CLERK'S COPY

TRANSCRIPT OF RECORD

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1942

No. 22

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

vs.

R. A. SPROUSE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

PETITION FOR CERTIORARI FILED JANUARY 21, 1942
CERTIORARI GRANTED MAY 11, 1942

No. 9751

United States

Circuit Court of Appeals

For the Ninth Circuit.

R. A. SPROUSE,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Transcript of the Record

Upon Petition to Review a Decision of the United States Board of Tax Appeals

PARKER PRINTING COMPANY, 545 SANSOME STREET, SAN FRANCISCO

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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in italic; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in italic the two words between which the omission seems to occur.]

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APPEARANCES

For Taxpayer:
WILLIAM J. PIEPENBRINK, C.P.A.
CHAS. E. McCULLOCH, Esq.
THOS. B. STOEL, JR., Esq.

For Commissioner:
JOHN H. PIGG, Esq.

Docket No 98565

R. A. SPROUSE,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DOCKET ENTRIES

1939

May 17—Petition received and filed. Taxpayer notified. (Fee paid)

" 17—Copy of petition served on General Counsel.

Jul. 5—Answer filed by General Counsel.

" 5—Request for Circuit hearing in Portland, Oregon filed by General Counsel.

" 10—Notice issued placing proceeding on Portland, Oregon calendar. Answer and request served.

Oct. 4—Hearing set Nov. 20, 1939 at Portland, Oregon.

1939

Nov. 24—Hearing had before Mr. Smith on merits. Submitted. Consolidated for hearing with dockets 98452, 98564, 5, 6, 7 & 8. Appearance of Charles E. McCulloch and Thos. B. Stoel, Jr. filed. Stipulation of Facts filed. Memo Authorities filed by respondent. Copy served on petitioner. Petitioner's brief due 1/2/40—respondent's due 2/1/40. Called 11/20/39.

Dec. 13—Transcript of hearing of 11/24/39, filed.

1940

Jan. 2—Brief and proposed findings of fact filed by taxpayer. 1/2/40 copy served.

Aug. 6—Findings of fact and opinion rendered, Smith, Div. 5. Decision will be entered for the respondent.

" 8—Decision entered, Smith, Div. 5.

Nov. 1—Petition for review by U. S. Circuit Court of Appeals, 9th Circuit, with assignments of error filed by taxpayer.

" 1—Proof of service filed by taxpayer.

1941

Jan. 17—Certified copy of order from the 9th Circuit extending the time to 2/15/41 for filing the record and further ordered copy of this order be included in the certified record transmitted to the Court filed.

1941

Jan. 30—Praecipe for record filed by taxpayer with proof of service thereon. No counter praecipe to be filed.

" 30—Notice of filing praecipe for record filed by taxpayer with proof of service thereon.

[1*]

United States Board of Tax Appeals

Docket No. 98565

R. A. SPROUSE,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION

The above named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency IT:90D:JAS dated February 25, 1939, and as a basis of his proceeding, alleges as follows:

1. The petitioner is an individual residing in the City of Oakland, County of Alameda, State of California, and his residence address is 244 Lakeside Drive, Oakland, California. The return for the period here involved was filed with the Collector for the First District of California.

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*Page numbering appearing at foot of page of original certified Transcript of Record.

2. The notice of deficiency (a copy of which is attached and marked Exhibit "A"), was mailed to the petitioner on February 25, 1939.

3. The taxes in controversy are income taxes for the year 1936, and in the amount of $16,562.37.

4. The determination of the tax set forth in the said notice of deficiency is based upon the following errors:

(a) The Commissioner erred in failing and refusing to find that stock dividends paid during the year 1936 by [2] Sprouse-Reitz Co. Inc., in non-voting Common Stock on voting Common Stock, and in 7% Preferred Stock on voting Common Stock, do not constitute income under the Sixteenth Amendment.

(b) The Commissioner erred in failing and refusing to find that stock dividends in non-voting Common Stock on voting Common Stock, and in 7% Preferred Stock on voting Common Stock paid to petitioner by Sprouse-Reitz Co. Inc., during the year 1936 were not taxable dividends under Section 115(f) of Revenue Act of 1936.

5. The facts upon which the petitioner relies as the basis of this proceeding are as follows:

(a) During the year 1936 Sprouse-Reitz Co. Inc., paid stock dividends to petitioner in non-voting Common Stock on voting Common Stock, and in 7% Preferred Stock on voting Common Stock, which did not change his proportion of ownership in the net assets of the Corporation.

(b) After receipt of said stock dividends petitioner's interest in the net assets of Sprouse-Reitz Co. Inc., remained the same as before.

Wherefore, the petitioner prays that this Board may hear the proceeding and find that the additional income taxes asserted by respondent are erroneous and not due from petitioner.

WILLIAM J. PIEPENBRINK,
Counsel for Petitioner,
603-5 Wilcox Building,
Portland, Oregon. [3]

State of California,
County of Alameda—ss.

R. A. Sprouse, being duly sworn, says that he is the petitioner named in the foregoing petition; that he has read the same or had the same read to him and is familiar with the statements contained therein; that the statements made therein are true, except those stated to be upon information and belief, and that those he believes to be true.

R. A. SPROUSE

Witness:
[Illegible]

Subscribed and sworn to before me this 11th day of May, 1939.

[Seal] HARRY BLAIR [4]

Treasury Department
Internal Revenue Service,
Seattle, Washington

February 25, 1939

Seattle Division
350 Federal Office Building
IT:90D:JAS

Mr. R. A. Sprouse
c/o Mr. William J. Piepenbrink,
903-4 Wilcox Building,
Portland, Oregon

Sir:

You are advised that the determination of your income tax liability for the taxable year ended December 31, 1936, discloses a deficiency of $16,562.37 as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency mentioned.

Within 90 days (Not counting Sunday or a legal holiday in the District of Columbia, as the 90th day) from the date of the mailing of this letter, you may file a petition with the United States Board of Tax Appeals for a redetermination of the deficiency.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to Internal Revenue Agent in charge, Seattle, Washington for the attention of IT:90D:JAS. The signing and filing of this form will expedite the

closing of your return(s) by permitting an early assessment of the deficiency, and will prevent the accumulation of interest, since the interest period terminates 30 days after filing the form, or on the date assessment is made, whichever is earlier.

Respectfully,

GUY T. HELVERING,
Commissioner.

By GEO. C. EARLEY,
Internal Revenue Agent in Charge.

Enclosures:
Statement.
Form of Waiver.

JAS-bb [5]

STATEMENT

IT:90D:JAS

R. A. Sprouse,
c/o William J. Piepenbrink,
903-4 Wilcox Building,
Portland, Oregon

Tax Liability for the Taxable Year Ended December 31, 1936

	Liability	Assessed	Deficiency
Income Tax	$22,656.84	$6,094.47	$16,562.37

In making this determination of your income tax liability, careful consideration has been given to the report of examination dated June 4, 1938; to your protest dated July 9, 1938; and to the statements made at the conferences held on August 25, 1938, and January 10, 1939.

A copy of this letter and statement has been mailed to your representative, William J. Piepenbrink, 903-4 Wilcox Building, Portland, Oregon, in accordance with the authority contained in the power of attorney executed by you on file with the Bureau.

ADJUSTMENTS TO NET INCOME

Net income as disclosed by return	$40,357.88
Unallowable deductions and additional income:	
(a) Additional dividends	42,300.00
Net income adjusted	$82,657.88

EXPLANATION OF ADJUSTMENTS

(a) It is held that stock dividends paid to you during the taxable year 1936 by Sprouse-Reitz Co., Inc., in nonvoting common stock on voting common stock and in 7% preferred stock on voting common stock, constitute income under the Sixteenth Amendment to the Constitution and taxable dividends under Section 115(f) of the Revenue Act of 1936, to the extent of their fair market value at the time received by you, which is held to be their par value. [6]

COMPUTATION OF TAX

Taxable Year Ended December 31, 1936

Net income as adjusted	$82,657.88
Less:	
Personal exemption	2,500.00
Balance (Surtax net income)	$80,157.88
Less:	
Earned income credit (10% of $7,500.00)	750.00
	$79,407.88

Normal tax at 4% on $79,407.88	$ 3,176.32
Surtax on $76,157.88 (excess over $4,000.00)	19,480.52
Correct income tax liability	$22,656.84
Income tax assessed:	
Original. Account No. 204895 (1-Calif.)	6,094.47
Deficiency of income tax	$16,562.37

[Endorsed]: U. S. B. T. A. Filed May 17, 1939.

[7]

[Title of Board and Cause.]

ANSWER

Comes Now the Commissioner of Internal Revenue, by his attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, and for answer to the petition filed herein, admits and denies as follows:

1. Admits the allegations contained in paragraph 1 of the petition.

2. Admits the allegations contained in paragraph 2 of the petition.

3. Admits the allegations contained in paragraph 3 of the petition.

4. Denies that he erred in his determination of the deficiency as shown by the notice of deficiency from which petitioner's appeal is taken. Specifically denies that he erred in the manner and form as alleged in subparagraphs (a) and (b) of paragraph 4 of the petition.

5(a) Admits that during the year 1936 Sprouse-Reitz Co. Inc., paid stock dividends to petitioner. For lack of sufficient information upon the basis of which to form a belief as to the truth or falsity thereof, denies the remaining allegations contained in sub- [8] paragraph (a) of paragraph 5 of the petition.

(b). Denies the allegations contained in sub-paragraph (b) of paragraph 5 of the petition.

6. Denies generally and specifically each and every material allegation contained in the petition herein, not hereinbefore specifically admitted, qualified, or denied.

Wherefore, it is prayed that the petitioner's appeal be denied and that the Commissioner's determination of deficiency be approved.

Signed J. P. WENCHEL,
JHP,
Chief Counsel, Bureau of Internal Revenue.

Of Counsel:
ALVA C. BAIRD,
B. H. NEBLETT,
JOHN H. PIGG,
Special Attorneys,
Bureau of Internal Revenue.

[Endorsed]: U. S. B. T. A. Filed July 5, 1939.
JWP:[illegible] Jun. 27, 1939. [9]

United States Board of Tax Appeals

Docket No. 98452

JOHN M. KEISTER,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Docket No. 98564

TRUST OF JOHN A. SPROUSE, UNITED STATES NATIONAL BANK OF PORTLAND (OREGON), TRUSTEE,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Docket No. 98565

R. A. SPROUSE,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Docket No. 98566

J. A. SPROUSE,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent. [10]

Docket No. 98567

JENNIE G. SPROUSE,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Docket No. 98568

CARRIE S. SPROUSE,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

STIPULATION OF FACTS

It is hereby stipulated and agreed by and between the parties hereto, by their respective attorneys, that the following facts are true, and that the same may be so taken and considered by the Board as offered in evidence by the parties to these proceedings.

1. Each of the petitioners is a stockholder of Sprouse-Reitz Co., Inc., which was organized under the laws of the State of Oregon, on February 10, 1920. The petitioners, John M. Keister, J. A. Sprouse, and Carrie S. Sprouse, are residents of Portland, Oregon, and filed their returns for the year 1936 with the Collector at Portland, Oregon. The petitioners, R. A. Sprouse and Jennie G. Sprouse, husband and wife, are residents of Oak-

land, California, and filed their returns for the year 1936 with the Collector for the First District of California. No income tax return (Form 1040) was filed by or for the petitioner, Trust of John A. Sprouse, for the year 1936, although a [11] fiduciary return of income (Form 1041) was filed for that petitioner for that year by the trustee, The United States National Bank, of Portland, (Oregon), with the Collector at Portland, Oregon.

2. On February 13, 1936, the Sprouse-Reitz Co., Inc., hereinafter referred to as the Company, had an authorized capital stock of $2,000,000.00 (par value), consisting of: (a) 6,000 shares voting common stock, of the par value of $100.00 per share; (b) 12,000 shares non-voting common stock, of the par value of $100.00 per share; and (c) 2,000 shares non-voting 7% cumulative preferred stock, of the par value of $100.00 per share, of which, there was outstanding at that time voting common stock of the par value of $397,471.25, and non-voting common stock of the par value of $819,333.06. None of the authorized preferred stock was outstanding at that time. The Company's articles of incorporation contain the following provision:

> "The preferred stock shall be entitled to a dividend of 7% annually upon the par value before any dividends are paid on either class of the common stock. The common stock shall be entitled to dividends equally on each class thereof after the dividends on the preferred stock are paid.

"The preferred stock and the non-voting common stock shall have no voting power. The preferred stock shall be made redeemable at any time after three years from the date of its issue, in the discretion of the board of directors, but such redemption shall be at par, and after all accrued dividends have been paid. In the event of liquidation or dissolution of the corporation all classes of stock shall share equally in the assets."

3. On February 13, 1936, the Company paid a 6% cash dividend of $73,008.26, of which $24,200.00 was paid to the holders of its voting [12] common stock, and $48,808.26 was paid to the holders of its non-voting common stock. On the same date, February 13, 1936, the Company paid a 10% stock dividend of $121,680.43 (par value) in non-voting common stock, of which $40,333.34 was paid to the holders of its voting common stock, and $81,347.09 was paid to the holders of its non-voting common stock.

4. On December 15, 1936, the Company paid a 10% cash dividend of $141,828.23, of which $42,633.33 was paid to the holders of its voting common stock, and $99,194.90 was paid to the holders of its non-voting common stock. On the same date, December 15, 1936, the Company paid a 10% stock dividend of $141,828.23 (par value) in non-voting 7% preferred stock, of which $42,633.33 was paid to the holders of its voting common stock and

$99,194.90 was paid to the holders of its non-voting common stock.

5. All of the Company's stockholders participated in the dividend distribution of February 13, 1936, and December 15, 1936, in proportion to their respective stockholdings, irrespective of whether they held voting or non-voting common stock. The fair market value of the Company's non-voting common stock at the time of the distribution thereof to its stockholders as a stock dividend, on February 13, 1936, was $100.00 per share. The fair market value of the Company's non-voting 7% preferred stock at the time of the distribution thereof to its stockholders as a stock dividend, on December 15, 1936, was $100.00 per share. On February 13, 1936, the Company's earnings or profits [13] available for distribution were of an amount of not less than $200,000.00, and on December 15, 1936, the Company's earnings or profits available for distribution were of an amount of not less than $300,000.00.

6. The following tabulation shows: (a) the amount (par value) of the Company's non-voting common stock received by the petitioners on February 13, 1936, as a dividend on their non-voting common stock; (b) the amount (par value) of the Company's non-voting common stock received by the petitioners on February 13, 1936, as a dividend on their voting common stock; (c) the amount (par value) of the Company's 7% preferred stock received by the petitioners on December 15, 1936,

as a dividend on their voting common stock; (d) the amount (par value) of the Company's 7% preferred stock received by the petitioners on December 15, 1936, as a dividend on their non-voting common stock; and (e) the amounts by which the Commissioner has increased the net incomes as reported by the respective petitioners for the year 1936; [14].

	(a) Non-voting common stock (par value) received on 2-13-36, as dividend on non-voting common stock	(b) Non-voting common stock (par value) received on 2-13-36, as dividend on voting common stock	(c) Non-voting 7% preferred stock (par value) received on 12-15-36, as dividend on voting common stock	(d) Non-voting 7% preferred stock (par value) received on 12-15-36, as dividend on non-voting common stock	(e) Amounts by which petitioners' reported income for 1936 has been increased by respondent
Trust of John A. Sprouse, Deceased	—	$8,000.00	$8,000.00	$ 800.00	$16,800.00
J. A. Sprouse	$ 414.73	4,508.72	4,508.72	907.07	9,924.51
Carrie S. Sprouse	1,909.99	3,193.46	3,779.67	2,420.33	9,979.67
R. A. Sprouse	—	20,000.00	22,300.00	- -	42,300.00
Jennie G. Sprouse	83.45	317.90	317.90	123.59	759.39
John M. Keister	2,028.88	1,721.12	1,721.12	2,028.88	5,471.12

7. In none of the returns filed by or for any of the petitioners for the year 1936 was there any amount reported for or on account of the stock dividends received by them during that year, as above set forth. In his determination of the deficiencies involved, the Commissioner increased the net incomes as reported by the petitioners for the year [illegible] by the respective amounts as shown in column (e) of paragraph 6, above, on the ground that the stock dividends in question, both non-voting common and preferred, constitute taxable income under the Sixteenth Amendment to the Constitution, and within the meaning of section 115(f) of the Revenue Act of 1936. It was further held by the Commissioner that the stock dividends represented taxable income to the extent of their fair market value, which was determined by him to be equal to their par value. No part of the amounts appearing in column (a) of paragraph 6, above, has been included by the [15] Commissioner in the taxable incomes, as determined by him, of the petitioners opposite whose names such amounts appear.

8. The amount of $9,979.67, appearing in column (e) of paragraph 6, above, as representing the amount by which respondent increased the net income as reported by Carrie S. Sprouse for the year 1936, included the sum of $3,779.67, as the amount of the non-voting common stock (par value) received by her on February 13, 1936, as a dividend on voting common stock, instead of the amount of

$3,193.46, shown in column (b) of paragraph 6, above.

/S/ CHARLES E. McCULLOCH,
/S/ THOMAS B. STOEL, JR.,
Counsel for Petitioner.
/S/ J. P. WENCHEL, ACB,
Chief Counsel, Bureau of Internal Revenue,
Counsel for Respondent.

JHP:[Illegible] 11-17-39

[Endorsed]: U. S. B. T. A. Filed at hearing. Nov. 24, 1939. [16]

United States Board of Tax Appeals

JOHN M. KEISTER,

Petitioner,[1]

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Docket Nos. 98452, 98564-98568.

Promulgated August 6, 1940.

FINDING OF FACT AND OPINION

1. A stock dividend paid in non-voting common stock to the holders of voting common

[1] Proceedings of the following petitioners are consolidated herewith: Trust of John A. Sprouse United States National Bank of Portland (Oregon) Trustee; R. A. Sprouse; J. A. Sprouse; Jennie G. Sprouse; and Carrie S. Sprouse.

stock and nonvoting common stock is a taxable dividend to the holders of voting common stock.

2. A stock dividend paid in nonvoting 7 percent preferred stock to the holders of voting common stock and to the holders of nonvoting common stock is a taxable dividend to both classes of stockholders. Koshland v. Helvering, 298 U. S. 446.

CHARLES E. McCULLOCH, Esq.,
and
THOMAS B. STOEL, JR., Esq.,
For the Petitioners.

JOHN H. PIGG, Esq.,
For the respondent.

These proceedings, consolidated for hearing, involve income tax deficiencies for 1936 as follows:

Petitioner	Docket No.	Deficiency
John M. Keister	98452	$510.92
Trust of John A. Sprouse, United States National Bank of Portland (Oregon), Trustee	98564	1,394.00
R. A. Sprouse	98565	16,562.37
J. A. Sprouse	98566	1,329.97
Jennie G. Sprouse	98567	75.95
Carrie S. Sprouse	98568	2,197.87

The petitioners allege that the respondent erred in including in their gross income the value of certain shares of stock issued to them as stock dividends in nonvoting common stock and in nonvoting 7 percent preferred stock of the Sprouse-Reitz Co. All of the facts have been stipulated.

FINDINGS OF FACT.

1. Each of the petitioners is a stockholder of Sprouse-Reitz Co., a corporation organized under the laws of the State of Oregon on [17] February 10, 1920. The petitioners, John M. Keister, J. A. Sprouse, and Carrie S. Sprouse, are residents of Portland, Oregon, and filed their returns for 1936 with the collector at Portland. The petitioners, R. A. Sprouse and Jennie G. Sprouse, are husband and wife and are residents of Oakland, California. They filed their returns for the year 1936 with the collector for the first district of California. No income tax return (Form 1040) was filed by or for the petitioner, Trust of John A. Sprouse, for the year 1936, although a fiduciary return of income (Form 1041) was filed for the petitioner for that year by the trustee, the United States National Bank of Portland, with the collector at Portland.

2. On February 13, 1936, the Sprouse-Reitz Co., hereinafter sometimes referred to as the company, had an authorized capital stock of $2,000,000 (par value) consisting of: (a) 6,000 shares of voting common stock of the par value of $100 per share; (b) 12,000 shares of nonvoting common stock of the par value of $100 per share; and (c) 2,000 shares of nonvoting 7 percent cumulative preferred stock of the par value of $100 per share, of which there was outstanding at that time voting common stock of the par value of $397,471.25, and nonvoting common stock of the par value of $819,333.06. None of the authorized preferred stock was outstanding at

that time. The company's articles of incorporation contain the following provision:

> The preferred stock shall be entitled to a dividend of 7 percent annually upon the par value before any dividends are paid on either class of the common stock. The common stock shall be entitled to dividends equally on each class thereof after the dividends on the preferred stock are paid.
>
> The preferred stock and the nonvoting common stock shall have no voting power. The preferred stock shall be made redeemable at any time after three years from the date of its issue, in the discretion of the board of directors, but such redemption shall be at par, and after all accrued dividends have been paid. In the event of liquidation or dissolution of the corporation all classes of stock shall share equally in the assets.

3. On February 13, 1936, the company paid a 10 percent stock dividend on its voting and nonvoting common stock of $121,680.43 (par value) in nonvoting common stock, of which $40,333.34 was paid on its voting common stock and $81,347.09 on its nonvoting common stock.

4. On December 15, 1936, the company paid a 10 percent stock dividend on its voting and nonvoting common stock of $141,828.23 (par value) in nonvoting 7 percent preferred stock, of which $42,633.33 was paid on its voting common stock, and $99,194.90 on its nonvoting common stock.

5. All of the company's stockholders, whether they held voting or nonvoting common stock, participated in the dividend distributions of February 13 and December 15, 1936, in proportion to their respec- [18] tive stockholdings. The fair market value of the company's nonvoting common stock at the time of the distribution thereof to its stockholders as a stock dividend on February 13, 1936, was $100 per share. The fair market value of the company's nonvoting 7 percent preferred stock at the time of the distribution thereof to its stockholders as a stock dividend on December 15, 1936, was $100 per share.

6. The following tabulation shows (a) the amount (par value) of the company's nonvoting common stock received by the petitioners on February 13, 1936, as a dividend on their nonvoting common stock; (b) the amount (par value) of the company's nonvoting common stock received by the petitioners on February 13, 1936, as a dividend on their voting common stock; (c) the amount (par value) of the company's 7 percent preferred stock received by the petitioners on December 15, 1936, as a dividend on their voting common stock; (d) the amount (par value) of the company's 7 percent preferred stock received by the petitioners on December 15, 1936, as a dividend on their nonvoting common stock; and (e) the amounts by which the respondent has increased the net incomes as reported by the respective petitioners for the year 1936:

Name	(a) Non-voting common stock (par value) received on 2-13-36, as dividend on non-voting common stock	(b) Non-voting common stock (par value) received on 2-13-36, as dividend on voting common stock	(c) Non-voting 7% preferred stock (par value) received on 12-15-36, as dividend on voting common stock	(d) Non-voting 7% preferred stock (par value) received on 12-15-36, as dividend on non-voting common stock	(e) Amounts by which petitioners' reported income for 1936 has been increased by respondent
Trust of John A. Sprouse, Deceased	—	$8,000.00	$8,000.00	$ 800.00	$16,800.00
J. A. Sprouse	$ 414.73	4,508.72	4,508.72	907.07	9,924.51
Carrie S. Sprouse	1,909.99	3,193.46	3,779.67	2,420.33	9,979.67
R. A. Sprouse	—	20,000.00	22,300.00	—	42,300.00
Jenhie G. Sprouse	83.45	317.90	317.90	123.59	759.39
John M. Keister	2,028.88	1,721.12	1,721.12	2,028.88	5,471.12

7. In none of the returns filed by or for any of the petitioners for the year 1936 was there reported any amount on account of the stock dividends received by them during that year as above set forth. In his determination of the deficiencies involved the respondent increased the net incomes as reported by the petitioners for the year 1936 by the respective amounts as shown in column (e) of paragraph 6, above, on the ground that the stock dividends in question, both nonvoting common and preferred, constituted taxable income under the Sixteenth Amendment to the Constitution and within the meaning of section 115 (f) of the Revenue Act of 1936. It was further held by the respondent that the stock dividends represented taxable income to the extent of their fair market value, which was determined by him to be equal to their par value. No part of the amounts ap- [19] pearing in column (a) of paragraph 6, above, has been included by the respondent in the taxable incomes of the respective petitioners as determined by him.

8. The amount of $9,979.67, appearing in column (e) of paragraph 6, above, as representing the amount by which respondent increased the net income as reported by Carrie S. Sprouse for the year 1936, included the sum of $3,779.67 as the amount of the nonvoting common stock (par value) received by her on February 13, 1936, as a dividend on voting common stock, instead of the amount of $3,193.46 shown in column (b) of paragraph 6, above.

OPINION.

Smith: The questions for our determination in these proceedings are whether the distributions which the Sprouse-Reitz Co. made in 1936 of its nonvoting common stock to holders of voting common stock, and of its nonvoting 7 percent preferred stock to holders of its voting common stock and its nonvoting common stock were taxable dividends within the meaning of section 115 (f) of the Revenue Act of 1936.

Section 115 of the Revenue Act of 1936 provides in part:

> Sec. 115. Distributions by Corporations.
>
> (a) Definition of Dividend.—The term "dividend" when used in this title (except in section 203 (a) (3) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.
>
> * * * * * *
>
> (f) Stock Dividends.—
>
> (1) General Rule.—A distribution made by a corporation to its shareholders in its stock

or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution.

In Eisner v. Macomber, 252 U. S. 189, it was held that a distribution of common stock as a dividend on common stock did not constitute income within the meaning of the Sixteenth Amendment and that an income tax law attempting to tax such a stock dividend was invalid. In Koshland v. Helvering, 298 U. S. 441, it was held that common voting stock issued as a dividend on cumulative nonvoting preferred stock constituted income to the recipients and not return of capital. In its opinion the Court sad:

> Although Eisner v. Macomber affected only the taxation of dividends declared in the same stock as that presently held by the taxpayer, the Treasury [20] gave the decision a broader interpretation which Congress followed in the act of 1921. Soon after the passage of that act, this court pointed out the distinction between a stock dividend which worked no change in the corporate entity, the same interest in the same corporation being represented after the distribution by more shares of precisely the same character, and such a dividend where there had either been changes of corporate identity or a change in the nature of the shares issued as dividends whereby the proportional interest of the stockholder after the distribu-

> tion was essentially different from his former interest. * * * [Citing United States v. Phellis, 257 U. S. 156; Rockefeller v. United States, 257 U. S. 176; Cullinan v. Walker, 262 U. S. 134; Marr v. United States, 268 U. S. 536.]
>
> * * * Under our decisions the payment of a dividend of new common shares, conferring no different rights or interests than did the old, the new certificates, plus the old, representing the same proportionate interest in the net assets of the corporation as did the old, does not constitute the receipt of income by the stockholder. On the other hand, where a stock dividend gives the stockholder an interest different from that which his former stock holdings represented he receives income. The latter type of dividend is taxable as income under the Sixteenth Amendment. * * *

At the time the corporation here made the dividend distribution of its nonvoting common stock on February 13, 1936, there were outstanding only two classes of stock, voting common shares and nonvoting common shares. The holders of both classes of stock shared alike in the distribution. The Commissioner treated the distribution as a taxable dividend to the voting common stockholders but not to the nonvoting common stockholders.

The respondent makes the argument that the voting shares and the nonvoting shares represented different property rights and that the holders of the nonvoting shares might have transferred them

without in any way disturbing the voting control, citing Frank J. and Hubert Kelly Trust, 38 B. T. A. 1014. In that case there was a stock dividend of preferred shares on common shares, only common shares being outstanding at the time. The question at issue was whether in determining the profit upon the sale of the preferred shares they should be given a cost basis of an allocable portion of the cost of the common shares. We held that although by specific statute the dividend in the preferred shares was exempt from income tax as a stock dividend, such preferred shares were nevertheless income under the Sixteenth Amendment, and the decisions of the Supreme Court, and that the entire amount received from their subsequent sale constituted taxable income. The situation there was the converse of that in the Koshland case, where common voting shares were issued as a stock dividend on preferred nonvoting shares. In its opinion the Board said:

> * * * But entirely apart from this, the undeniable difference in the situation of the stockholders is that their interest, after the dividend, became to some extent transferable in parts where before it could be disposed of only as a [21] whole. Before the dividend, it is true, a stockholder could have sold a portion of his common shares. But, as pointed out in the Macomber case, supra, p. 212, it is "in the nature of things impossible for one to dispose of any part of such an issue without a proportionate disturbance of the distribution of the

entire capital stock." After the preferred stock was issued this was no longer true. Petitioner's donors, by transferring the preferred stock, as in fact they did, could then dispose of a part of their interest in the earnings and assets of the corporation without in any way disturbing the distribution of voting control. Or they could retain the preferred stock as representing a property interest and divest themselves of the powers of management. We find it impossible to conclude that this situation did not result in a substantial alteration of the interest of the stockholders. * * *

The portion of the Court's opinion in Eisner v. Macomber, supra, from which the above quotation was taken, reads as follows:

It is said that a stockholder may sell the new shares acquired in the stock dividend; and so he may, if he can find a buyer. It is equally true that if he does sell, and in doing so realizes a profit, such profit, like any other, is income, and so far as it may have arisen since the Sixteenth Amendment is taxable by Congress without apportionment. The same would be true were he to sell some of his original shares at a profit. But if a shareholder sells dividend stock he necessarily disposes of a part of his capital interest, just as if he should sell a part of his old stock, either before or after the dividend. What he retains no longer entitles him to the same proportion of future dividends as before

the sale. His part in the control of the company likewise is diminished. Thus, if one holding $60,000 out of a total $100,000 of the capital stock of a corporation should receive in common with other stockholders a 50 per cent. stock dividend, and should sell his part, he thereby would be reduced from a majority to a minority stockholder, having six-fifteenths instead of six-tenths of the total stock outstanding. A corresponding and proportionate decrease in capital interest and in voting power would befall a minority holder should he sell dividend stock; it being in the nature of things impossible for one to dispose of any part of such an issue without a proportionate disturbance of the distribution of the entire capital stock, and a like diminution of the seller's comparative voting power—that "right preservative of rights" in the control of a corporation. Yet, without selling, the shareholder, unless possessed of other resources, has not the wherewithal to pay an income tax upon the dividend stock. Nothing could more clearly show that to tax a stock dividend is to tax a capital increase, and not income, than this demonstration that in the nature of things it requires conversion of capital in order to pay the tax.

In Chapman v. United States, 63 Ct. Cls. 106, it was held under the doctrine of Eisner v. Macomber, supra, a distribution of nonvoting common stock as a dividend on voting common stock was a non-

taxable stock dividend. Certiorari was denied by the Supreme Court, 275 U. S. 524. Denial of Certiorari was, however, prior to the decision of the Supreme Court in Koshland v. Helvering, supra. As many times pointed out by the Supreme Court, denial of a writ of certiorari in a given case is not tantamount to the affirmance of the decision of the court below. [22]

We think that under the opinion of the Supreme Court in the Koshland case the petitioners who received on their voting common stock a dividend of nonvoting common shares received a taxable dividend. The nonvoting common stock was not "of precisely the same character" as the stock previously held by them. By the receipt of the dividend each holder of voting common stock received an "interest different from that which its former stockholdings represented." In making this observation we do not overlook the fact that the value of the additional nonvoting common shares received was presumably no greater than a like number of voting common shares which would not be subject to income tax under the opinion in Eisner v. Macomber, supra. Probably the shares had a less value. But the interest was different, and we think that is all that is required to make the dividend taxable to the holders of voting common stock.

The dividend of the 7 percent nonvoting preferred stock on the voting and nonvoting common stock, which was distributed December 15, 1936, presents a situation even more favorable to the

respondent. This stock was entitled to 7 percent annual dividends before any dividends could be paid on the common voting or nonvoting shares. It was redeemable at par after three years from the date of issue in the discretion of the directors and after payment of all accrued dividends. These features gave it an entirely different character from the voting and nonvoting common shares. It clearly represented a different interest in the corporation. It is true, as petitioners point out, that the preferred shares were not to be favored in case of liquidation or dissolution and it is to be noted further that their issuance did not in any way affect the voting control of the corporation, but nevertheless, under the authoritative cases, they represented a new and different interest in the corporation and therefore constituted taxable income. Koshland v. Helvering, supra; Frank J. and Hubert Kelly Trust, supra; Albert E. Smith, 39 B. T. A. 80.

Reviewed by the Board.

Decisions will be entered for the respondent in Docket Nos. 98452, 98564, 98565, 98566, and 98567, and under Rule 50 in Docket No. 98568.

[23]

United States Board of Tax Appeals
Washington

Docket No. 98565

R. A. SPROUSE,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DECISION

Pursuant to the determination of the Board, as set forth in its Findings of Fact and Opinion, promulgated August 6, 1940, it is

Ordered and Decided: That there is a deficiency in income tax of $16,562.37 for the year 1936.

Enter:

[Seal] (Sgd) CHARLES P. SMITH,
Member.

Entered Aug. 8, 1940. [24]

United States Circuit Court of Appeals
For the Ninth Circuit

Docket No. 98565

R. A. SPROUSE,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR REVIEW BY THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

To the Honorable, the Judges of the United States Circuit Court of Appeals for the Ninth Circuit:

I.

Jurisdiction

R. A. Sprouse, your petitioner, respectfully petitions this Honorable Court to review the decision of the United States Board of Tax Appeals entered on August 6, 1940, and finding a deficiency in income tax due from your petitioner for the calendar year 1936 in the amount of $16,562.37.

Your petitioner at the time of filing this petition [25] is a citizen of the United States and resides at Oakland, Alameda County, California.

The return of income tax in respect of which the aforementioned tax liability arose was filed by your petitioner with the Collector of Internal Revenue for the First Collection District of California lo-

cated in the City of San Francisco, California, which is situated within the jurisdiction of the Circuit Court of Appeals for the Ninth Judicial District.

The jurisdiction of this Court to review the decision of the United States Board of Tax Appeals aforesaid is founded on Section 1141 and Section 1142 of the Internal Revenue Code.

II.

Nature of the Controversy

The proceeding was submitted to the Board of Tax Appeals on a stipulation of facts. The stipulated facts show that the petitioner is a resident of Oakland, California, and was, on February 13, 1936, the owner of certain shares of the voting common stock of Sprouse-Reitz Co., Inc., hereinafter called the "Company." On that date the Company declared a stock dividend in nonvoting common stock payable to the holders of its voting common stock. As a result of the stock dividend so [26] paid, petitioner received 200 shares of the Company's nonvoting common stock of a total par value of $20,000. The fair market value of such nonvoting common stock on February 13, 1936, was $100 per share. The Company's earnings or profits available for distribution on February 13, 1936, were not less than $200,000.

The stipulated facts further show that on February 13, 1936, the Company had authorized and outstanding voting common stock of the par value

of $397,471.25 and nonvoting common stock of the par value of $819,333.06. The voting common stock and the nonvoting common stock conferred precisely the same rights upon shareholders, except that the nonvoting common stock had no voting power. The Company had no other classes of stock outstanding on February 13, 1936.

The Commissioner of Internal Revenue determined that the petitioner's taxable income for 1936 should include the sum of $20,000 on the ground that the stock dividend in nonvoting common stock paid by the Company on February 13, 1936, to holders of its voting common stock resulted in the receipt by petitioner of taxable income to the extent of the fair market value of the nonvoting common shares so received by him. The petitioner filed his petition to the Board of Tax Appeals seeking a redetermination of the deficiency [27] asserted by the Commissioner, and alleging error in the Commissioner's failure to find that the stock dividend paid to the petitioner in nonvoting common stock upon his voting common stock did not constitute income within the meaning of the Sixteenth Amendment to the Constitution of the United States and was not a taxable dividend under Section 115(f) of the Revenue Act of 1936.

In the proceedings before the Board the petitioner contended that the payment of the stock dividend in nonvoting common stock upon voting common stock, at a time when only common stock of both classes was outstanding, did not alter his

pre-existing proportionate interest in the Company nor give him substantially different interests in the Company. Therefore petitioner asserted that the distribution of such nonvoting common stock as a dividend on voting common stock did not constitute income within the meaning of the Sixteenth Amendment to the Constitution, and was not a taxable dividend under Section 115(f) of the Revenue Act of 1936.

No review is here sought of the Board's decision and order with respect to other issues raised by petitioner's petition to the Board.

The Board of Tax Appeals held:

(1) That the distribution which the Sprouse-Reitz Co., Inc., made on February 13, 1936, of its nonvoting common stock to holders of its voting common stock constituted [28] income within the meaning of the Sixteenth Amendment to the Constitution of the United States.

(2) That the distributions which the Sprouse-Reitz Co., Inc., made on February 13, 1936, of its nonvoting common stock to holders of its voting common stock were taxable dividends within the meaning of Section 115(f) of the Revenue Act of 1936.

III.

ASSIGNMENT OF ERRORS

In making its decision as aforesaid the United States Board of Tax Appeals committed the fol-

lowing errors upon which your petitioner relies as the basis of this proceeding:

1. The Board erred in holding that the distributions of nonvoting common stock to holders of voting common stock in Sprouse-Reitz Co., Inc., were income within the meaning of the Sixteenth Amendment to the Constitution of the United States.

2. The Board erred in holding that distributions in nonvoting common stock to holders of voting common stock in Sprouse-Reitz Co., Inc., were taxable dividends under Section 115(f) of the Revenue Act of 1936.

3. The Board erred in holding that the fair market [29] value of the nonvoting common stock received by petitioner on February 13, 1936, as a dividend upon his voting common stock should be included in petitioner's income for the calendar year 1936.

4. The Board erred in rendering its decision in favor of respondent and against petitioner for a deficiency of $16,562.37, or for any deficiency in excess of $7,297.11 in petitioner's income tax for the calendar year 1936.

Wherefore, your petitioner prays that this Honorable Court may review the decision and order of the United States Board of Tax Appeals and reverse and set aside the same to the extent that it holds that the nonvoting common stock received by petitioner as a dividend upon his voting common stock constituted taxable income to him; and for the entry of such further orders and directions as

shall by this Court be deemed meet and proper, in accordance with law.

CHARLES E. McCULLOCH,
THOMAS B. STOEL, JR.,
Counsel for Petitioner,
1410 Yeon Building,
Portland, Oregon. [30]

State of Oregon,
County of Multnomah—ss.

Charles E. McCulloch, being duly sworn, says:

I am one of the attorneys for the petitioner in this proceeding; I prepared the foregoing petition and am familiar with the contents thereof. The allegations of fact contained therein are true to the best of my knowledge, information and belief. This petition is not filed for the purpose of delay, and I believe the petitioner is justly entitled to the relief sought.

CHARLES E. McCULLOCH

Subscribed and sworn to before me this 30th day of October, 1940.

(Notarial Seal) T. A. RUTHERFORD
Notary Public for Oregon

My commission expires: Oct. 6, 1943

[Endorsed]: U.S.B.T.A. Filed Nov. 1, 1940. [31]

[Title of Board and Cause.]

NOTICE OF FILING PETITION FOR REVIEW AND ACCEPTANCE OF SERVICE THEREOF

To:

Commissioner of Internal Revenue,
Internal Revenue Building,
Washington, D. C.

J. P. Wenchel, Attorney for Respondent,
Chief Counsel,
Bureau of Internal Revenue,
Internal Revenue Building,
Washington, D. C.

You Are Hereby Notified that on the 1st day of November, 1940, a petition for review by the United States Circuit Court of Appeals for the Ninth Circuit of the decision [32] of the United States Board of Tax Appeals heretofore rendered in the above entitled cause, was filed with the Clerk of the Board. A copy of the petition as filed is attached hereto and served upon you.

Dated at Portland, Oregon, this 30th day of October, 1940.

CHARLES E. McCULLOCH
THOMAS B. STOEL, JR.
Counsel for Petitioner,
1410 Yeon Building,
Portland, Oregon.

Service of the foregoing Notice of Filing and of

a copy of the Petition For Review is hereby acknowledged this 1st day of November, 1940.

J. P. WENCHEL
C.P.R.
Chief Counsel, Bureau of Internal Revenue, Attorney for Respondent.

[Endorsed]: U.S.B.T.A. Filed Nov. 1, 1940. [33]

United States Circuit Court of Appeals
for the Ninth Circuit

No. 9751

(B. T. A. Docket No. 98565)

R. A. SPROUSE,

Petitioner.

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PRAECIPE FOR RECORD

To the Clerk of the United States Board of Tax Appeals:

You will please prepare, transmit, and deliver to the Clerk of the United States Circuit Court of Appeals for the Ninth Circuit copies duly certified of the following documents and records in the above entitled cause in connection with the petition for review by the said Circuit Court of Appeals for

the Ninth Circuit, heretofore filed by the above named petitioner:

1. The docket entries of the proceedings before the United States Board of Tax Appeals;
2. Petition filed on May 17, 1939; [34]
3. Answer filed on July 5, 1939;
4. Stipulation of facts filed with the Board at the hearing on November 24, 1939;
5. Findings of fact and opinion of the Board, promulgated August 6, 1940, and decision of the Board entered August 6, 1940;
6. Petition for review by the United States Circuit Court of Appeals for the Ninth Circuit, filed on November 1, 1940;
7. Notice of filing petition for review, filed on November 1, 1940;
8. This praecipe for record;
9. Notice of filing this praecipe for record and the admission of service thereof.

CHARLES E. McCULLOCH
THOMAS B. STOEL, JR.
Attorneys for Petitioner
1410 Yeon Building
Portland, Oregon

Service of a copy of this praecipe is hereby admitted this 30th day of January, 1941. A counter-praecipe will not be filed.

J. P. WENCHEL
W
Chief Counsel, Bureau of Internal Revenue, Attorney for Respondent

[Endorsed]: U.S.B.T.A. Filed Jan. 30, 1941. [35]

United States Circuit Court of Appeals
for the Ninth Circuit

[Title of Cause.]

NOTICE OF FILING PRAECIPE

To: Commissioner of Internal Revenue,
Internal Revenue Building,
Washington, D. C.

J. P. Wenchel, Attorney for Respondent,
Chief Counsel,
Bureau of Internal Revenue,
Internal Revenue Building,
Washington, D. C.

Please Take Notice that on the 30th day of January, 1941, the undersigned, attorneys for R. A. Sprouse, [36] the petitioner in the above entitled proceeding, have filed with the Clerk of the United States Board of Tax Appeals a Praecipe for Record, a copy of which is annexed hereto.

CHARLES E. McCULLOCH
THOMAS B. STOEL, JR.
Attorneys for Petitioner
1410 Yeon Building
Portland, Oregon

Dated: January 23, 1941

Receipt of the foregoing notice of filing the praecipe for record and service of a copy of the praecipe herein mentioned is acknowledged this 30th day of January, 1941.

J. P. WENCHEL
W
Chief Counsel, Bureau of Internal Revenue, Attorney for Respondent

[Endorsed]: U.S.B.T.A. Filed Jan. 30, 1941. [37]

United States Circuit Court of Appeals
for the Ninth Circuit

[Title of Cause.]

ORDER EXTENDING TIME FOR FILING RECORD UPON APPEAL

Upon application of R. A. Sprouse, petitioner in the foregoing proceeding, for extension of time to file in this court the record on appeal from an order of the United States Board of Tax Appeals finding a deficiency in the petitioner's federal income tax for the year 1936, and for cause shown,

It Is Ordered that the time for filing the record on appeal herein be and is hereby extended to February 15, 1941, and

It Is Further Ordered that the Clerk of this Court transmit a certified copy of the order of this Court entered hereunder to the Clerk of the United States Board of Tax Appeals, to be included by him in the certified record transmitted to this court.

Dated January 8th, 1941.

CURTIS D. WILBUR
U. S. Circuit Judge

[Endorsed]: Filed Jan. 8, 1941. Paul P. O'Brien, Clerk.

A True Copy

Attest: Jan. 13, 1941

(Seal) (s) PAUL P. O'BRIEN
Clerk.

[Endorsed]: U.S.B.T.A. Filed Jan. 17, 1941 [38]

[Title of Board and Cause.]

CERTIFICATE

I, B. D. Gamble, clerk of the U. S. Board of Tax Appeals, do hereby certify that the foregoing pages, 1 to 38, inclusive, contain and are a true copy of the transcript of record, papers, and proceedings on file and of record in my office as called for by the Praecipe in the appeal (or appeals) as above numbered and entitled.

In testimony whereof, I hereunto set my hand and affix the seal of the United States Board of Tax Appeals, at Washington, in the District of Columbia, this 3d day of February, 1941.

(Seal) B. D. GAMBLE

Clerk, United States Board of Tax Appeals.

[Endorsed]: No. 9751. United States Circuit Court of Appeals for the Ninth Circuit. R. A. Sprouse, Petitioner, vs. Commissioner of Internal Revenue, Respondent. Transcript of the Record. Upon Petition to Review a Decision of the United States Board of Tax Appeals.

Filed February 19, 1941.

PAUL P. O'BRIEN,

Clerk of the United States Circuit Court of Appeals for the Ninth Circuit.

United States Circuit Court of Appeals
for the Ninth Circuit

No. 9751

R. A. SPROUSE,

Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellee.

STATEMENT OF POINTS RELIED UPON AND DESIGNATION OF PARTS OF RECORD

Appellant, R. A. Sprouse, having filed his petition for review by the above entitled court of the decision of the Board of Tax Appeals entered on August 6, 1940, and finding a deficiency in federal income tax due from appellant for the calendar year 1936 in the amount of $16,562.37 specifies the following as the points upon which he intends to rely upon the appeal:

1. The Board erred in holding that the distributions of nonvoting common stock to holders of voting common stock in Sprouse-Reitz Co., Inc. were income within the meaning of the Sixteenth Amendment to the Constitution of the United States.

2. The Board erred in holding that distributions in nonvoting common stock to holders of voting common stock in Sprouse-Reitz Co., Inc., were taxable dividends under Section 115(f) of the Revenue Act of 1936.

3. The Board erred in holding that the fair market value of the nonvoting common stock received by appellant on February 13, 1936, as a dividend upon his voting common stock should be included in appellant's income for the calendar year 1936.

4. The Board erred in rendering its decision in favor of appellee and against appellant for a deficiency of $16,562.37, or for any deficiency in excess of $7,297.11 in appellant's income tax for the calendar year 1936.

Appellant hereby designates as the parts of the record which he thinks necessary for consideration the entire transcript of record as certified by the Clerk of the Board of Tax Appeals to the above entitled court, together with this statement of points relied upon and designation of parts of record.

CHARLES E. McCULLOCH
THOMAS B. STOEL, JR.
1410 Yeon Building,
Portland, Oregon.
Counsel for Appellant.

State of Oregon,
County of Multnomah—ss.

I, Thomas B. Stoel, Jr., being first duly sworn on oath depose and say:

On February 25, 1941, I deposited in the United States mail a registered letter containing a duly certified copy of the attached statement of points relied upon and designation of parts of record. Said

letter was addressed to the appellee's attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, Washington, D. C., with postage prepaid.

THOMAS B. STOEL, JR.

Subscribed and sworn to before me this 25th day of February, 1941.

(Seal) T. A. RUTHERFORD

Notary Public for Oregon

My commission expires Oct. 6, 1943.

[Endorsed]: Filed Feb. 27, 1941. Paul P. O'Brien, Clerk.

UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

No. 9751

R. A. SPROUSE

v.

COMMISSIONER OF INTERNAL REVENUE

Excerpt from Proceedings of Monday, September 15, 1941

Before GARRECHT, HANEY, and HEALY, Circuit Judges

Order of submission.

Ordered petition to review herein argued by Mr. Thomas B. Stoel, Jr., counsel for petitioner, and by Mr. Warren F. Wattles, Special Assistant to the Attorney General, counsel for respondent, and submitted to the court for consideration and decision.

Excerpt from Proceedings of Wednesday, October 22, 1941

Before GARRECHT, HANEY, and HEALY, Circuit Judges

Order directing filing of opinion and filing and recording of judgment

By direction of the Court, ordered that the typewritten opinion this day rendered by this Court in above cause be forthwith filed by the clerk, and that a judgment be filed and recorded in the minutes of this court in accordance with the opinion rendered.

In the United States Circuit Court of Appeals for the Ninth Circuit

No. 9751. Oct. 22, 1941

R. A. SPROUSE, PETITIONER

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Upon Petition to Review a Decision of the United States Board of Tax Appeals

Before GARRECHT, HANEY, and HEALY, Circuit Judges

HANEY, Circuit Judge.

Petitioner seeks review of a decision of the Board of Tax Appeals holding that a stock dividend received by him was taxable income.

Sprouse-Reitz Co., Inc., was organized under the laws of Oregon on February 20, 1920. On February 13, 1936, its capital stock authorized and issued, was as follows:

Class	Authorized	Issued
$100 par voting common	$800,000	$397,471.25
$100 par non-voting common	1,200,000	819,333.75
$100 par 7% cumulative preferred	200,000	none
Totals	2,000,000	1,216,805.00

Its articles of incorporation contained the following provisions:

"The preferred stock shall be entitled to a dividend of 7% annually upon the par value before any dividends are paid on either class of the common stock. The common stock shall be entitled to dividends equally on each class thereof after the dividends on the preferred stock are paid.

"The preferred stock and the non-voting common stock shall have no voting power. The preferred stock shall be made redeemable at any time after three years from the date of its issue, in the discretion of the board of directors, but such redemption shall be at par, and after all accrued dividends have been paid. In the event of liquidation or dissolution of the corporation all classes of stock shall share equally in the assets."

On February 13, 1936, the corporation distributed a 10% stock dividend in non-voting common stock, divided between the holders of voting common and non-voting common stock. On December 15, 1936, the corporation distributed a 10% stock dividend in 7% cumulative preferred stock, divided between the holders of voting common and non-voting common stock. The fair market value of the stocks so distributed was the par value thereof. The stock dividends were distributed in addition to the payment of cash dividends. At the time of the distribution of the stock dividend, the corporation's earnings or profits available for distribution were not less than $200,000.

Petitioner owned only voting common stock immediately prior to the declaration of the first stock dividend. He received non-voting common stock, pursuant to the first stock dividend, having a fair market value of $20,000. He received 7% cumulative preferred stock, pursuant to the second stock dividend, having a fair market value of $22,300. He reported neither amount in his income tax return for 1936. Respondent audited petitioner's return, included therein as taxable income received by petitioner in 1936, the amount of $42,300, and assessed a deficiency in tax. The Board upheld respondent. Petitioner then filed the instant petition seeking review of that part of the Board's decision which upheld the inclusion of $20,000 as taxable income, such amount

representing the value of the non-voting common stock received by petitioner as a dividend.

The Sixteenth Amendment of the Constitution provides in part that "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived. * * *" The Revenue Act of 1936, § 22, provides that "gross income" includes "dividends." Section 115 (f) (1) provides:

"A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution."

The Board held that the nonvoting common stock received by petitioner as a dividend was not "of precisely the same character," as the voting common stock, and each voting common stockholder received an "interest different from that which its former stockholdings represented." It concluded that the value of the nonvoting common stock was taxable income under Koshland v. Helvering, 298 U. S. 441.

It is conceded that under the taxing act the value of the nonvoting common stock, distributed to petitioner as a dividend, was taxable if it was "income" of the kind which the Sixteenth Amendment authorizes Congress to tax. Petitioner contends that the Sixteenth Amendment does not authorize taxation of the kind of income represented by the nonvoting common stock. Respondent contends to the contrary. A determination of what is meant by the word "income" in the Sixteenth Amendment will solve the question presented. The Sixteenth Amendment "did not extend the taxing power to new subjects, but merely removed the necessity which otherwise might exist for an apportionment among the States of taxes laid on income." Eisner v. Macomber, 252 U. S. 189, 206.

The meaning of the word "income" in the Sixteenth Amendment is the same as the word has, when "used in common speech" and is the gain derived from or through a sale or conversion of capital assets, from labor, or from both combined. Eisner v. Macomber, supra, 207. The same case explains that income is "not a gain accruing to capital, not a growth or increment of value in the investment; but a gain, a profit, something of exchangeable value proceeding from the property, severed from the capital however invested or employed, and coming in, being 'derived,' that is, received or drawn by the recipient (the taxpayer) for his separate use, benefit, and disposal; that is income derived from property" (p. 207).

Generally, insofar as the stockholder is concerned, the three main differences in stocks are in the rights (1) to an interest in the assets of the corporation, the differences being in the amount of such interest and the preference it may have over other interests in the corporation; (2) to dividends, the differences being in the absoluteness of the right, and whether such right is cumulative; and (3) to manage and control the corporate enture by voting.

The Board was of the view, as appellee argues here, that if the stock distributed as a dividend, differed in its nature from that held by the stockholder, the latter derived income. In other words, differences in such characteristics as preference in interest in the assets and in dividends, and the right to vote, are proposed as the test to determine whether the recipient of the stock dividend has derived income. We think such a test results from a misconstruction of the decisions of the Supreme Court.

As is well known, a corporation, except in a few instances, is an entity, distinct from the stockholders. When it has earnings, the stockholders do not, by reason of that fact, have income. When it segregates those earnings, even though such earnings have accumulated in a surplus, and declares a dividend payable in money, then the stockholder receives income,[1] or if the corporation takes from its surplus, assets and distributes them in kind to the stockholders, the latter derives income.[2] If the corporation keeps its earnings or profits and allows them to accumulate thus building up a surplus, the surplus belongs to the corporation, not the stockholders, and while the value of the stock may increase, the stockholders do not realize on the profits until the surplus, or part thereof is distributed to them, or until they dispose of their stock.

When the corporation accumulates a surplus, and then declares and distributes a dividend of its own stock, to determine whether the stockholders have received "income," actually and really is to determine whether the corporate earnings have been divided, segregated, or set apart for the stockholders. Thus if the corporation has only one class of stock, the stock dividend is not a representation of a division or segregation of earnings, because the distributed stock gives the stockholders nothing which they did not already have. The proportionate interests are the same, the value of the original stock decreases to the extent of the value of the distributed stock, and the net result is that the stock-

[1] Lynch v. Hornby, 247 U. S. 339

[2] Peabody v. Eisner, 247 U. S. 347

holder's shares have been split into two interests.[3] The same thing is true where the corporation transfers its assets to a second corporation in return for the latter's stock, and then exchanges such stock for its stock.[4]

Where the corporation has more than one class of stock, outstanding, and distributes a stock dividend to one class only, then the proportionate interests in the corporation are changed, because the class of stockholders who receive the dividend then have a greater interest in the assets of the corporation than those who did not receive the stock dividend.[5] There being a change in the proportionate interests, the recipients of the stock dividend have derived income. The same result obtains where the corporation transfers its assets to a second corporation in return for its stock, and then distributes as a dividend the stock of the second corporation. That portion of the distributed stock which represents surplus and profits, is a segregation of such profits, for the use of the stockholders in the first corporation and is income derived by them.[6]

Therefore, we believe the real test to be used in determining whether the stockholder who receives a dividend of stock in the same corporation has received income, is whether the distribution effects a change in the proportionate interests of the stockholders.

In the instant case, when the stock dividend was made there were two classes of stockholders. Both received the stock dividend, but the record does not show whether the proportionate interests changed. When the distribution of $121,680.43 was made in non-voting common stock, there was outstanding $397,471.25 in voting common stock, and $819,333.06 in non-voting common stock, making a total of $1,216,804.31. If the voting common stockholders received the same proportion of the distribution as $397,471.25 bears to $1,216,804.31, then we think petitioner had no "income" but if they received a different proportion than the one specified, petitioner derived "income."

The decision is reversed, and the cause is remanded for further proceedings in accordance with this opinion.

[Endorsed:] Opinion. Filed Oct. 22, 1941. Paul P. O'Brien, Clerk.

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[3] Towne v. Eisner, 245 U. S. 418; Eisner v. Macomber, 252 U. S. 189.

[4] Weiss v. Stearn, 265 U. S. 242.

[5] Koshland v. Helvering, 298 U. S. 441; Helvering v. Gowan, 302 U. S. 238.

[6] United States v. Phellis, 257 U. S. 156; Rockefeller v. United States, 257 U. S. 176; Cullinan v. Walker, 262 U. S. 134; Marr v. United States, 268 U. S. 536.

Judgment

This Cause came on to be heard on the Transcript of the Record from the United States Board of Tax Appeals and was duly submitted:

On consideration whereof, it is now here ordered and adjudged by this Court, that the Decision of the said Board of Tax Appeals in this Cause be, and hereby is reversed, and that this cause be, and hereby is remanded to the said Board of Tax Appeals for further proceedings in accordance with the opinion of this court.

[Endorsed:] Judgment. Filed and entered October 22, 1941. Paul P. O'Brien, Clerk.

Certificate of Clerk, U. S. Circuit Court of Appeals for the Ninth Circuit, to record certified under Rule 38 of the revised rules of the Supreme Court of the United States

I, Paul P. O'Brien, as Clerk of the United States Circuit Court of Appeals for the Ninth Circuit, do hereby certify the foregoing fifty-eight (58) pages, numbered from and including 1 to and including 58, to be a full, true, and correct copy of the entire record of the above-entitled case in the said Circuit Court of Appeals, made pursuant to request of counsel for the respondent, and certified under Rule 38 of the Revised Rules of the Supreme Court of the United States, as the originals thereof remain on file and appear of record in my office.

Attest my hand and the seal of the said the United States Circuit Court of Appeals for the Ninth Circuit, at the City of San Francisco, in the State of California, this 23rd day of December 1941.

[SEAL] PAUL P. O'BRIEN, *Clerk*.

U. S. GOVERNMENT PRINTING OFFICE, 1942

SUPREME COURT OF THE UNITED STATES

Order allowing certiorari

Filed May 11, 1942

On petition for writ of certiorari to the United States Circuit Court of Appeals for the Ninth Circuit.

The order of this Court dated March 2, 1942, denying certiorari in this case is vacated. The petition for writ of certiorari herein is granted, and the case is assigned for argument immediately following No. 1100, Strassburger vs. Commissioner of Internal Revenue.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

U. S. GOVERNMENT PRINTING OFFICE 1942

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No. ~~894~~ 22

In the Supreme Court of the United States

OCTOBER TERM, 1941

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

R. A. SPROUSE

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

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In the Supreme Court of the United States

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No. ——

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

R. A. SPROUSE

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

The Solicitor General, on behalf of Guy T. Helvering, Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgment of the Circuit Court of Appeals for the Ninth Circuit entered in the above case on October 22, 1941, reversing the decision of the United States Board of Tax Appeals.

OPINIONS BELOW

The findings and opinion of the Board of Tax Appeals (R. 19–33) are reported at 42 B. T. A.

484. The opinion of the Circuit Court of Appeals (R. 50) is reported at 122 F. (2d) 973.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on October 22, 1941 (R. 55). The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the owner of voting common stock of a corporation realized taxable income upon the receipt of a stock dividend paid in nonvoting common stock of the corporation.

CONSTITUTIONAL PROVISIONS, STATUTE, AND REGULATIONS INVOLVED

The constitutional provisions, statute and regulations involved are set forth in the Appendix, *infra*, pp. 12–17.

STATEMENT

The facts, as stipulated (R. 12–19) and as found by the Board (R. 21–25), may be summarized as follows:

The respondent, R. A. Sprouse, was the owner of voting common stock in Sprouse-Reitz Company, Inc., an Oregon corporation, which, on February 13, 1936, paid a 10 percent stock dividend in new shares of its nonvoting common stock. (R. 12, 14, 21, 22.) The corporation had outstanding only two classes of

stock, voting and nonvoting common stock having par values in the respective aggregate amounts of $397,471.25 and $819,333.06.[1] (R. 13, 21.) The stock dividend consisted of $121,680.43 par value nonvoting common stock which was distributed to the holders of both the voting and nonvoting common in proportion to their respective stockholdings.[2] (R. 14, 15, 22, 23.) The fair market value of the nonvoting common stock at the time of distribution was equal to its par value. (R. 15, 23.)

The earnings and profits of the corporation available for distribution at the time of the dividend were not less than $200,000.[3] (R. 15.)

The respondent received 200 shares of the nonvoting common stock having a fair market value of

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[1] The corporation had authorized capital stock of $2,000,000, consisting of 6,000 shares of voting common, 12,000 shares of nonvoting common, and 2,000 shares of nonvoting preferred stock, the shares of each class having a par value of $100 each (R. 13, 21).

[2] Although Finding 5 (R. 23) states that the distribution was "in proportion" to the respective stockholdings of both classes, Finding 3 (R. 22) gives specific figures that are slightly at variance with that conclusion. Thus, pursuant to Finding 3, the voting common received a $40,333.34 dividend in nonvoting common and the nonvoting common received an $81,347.09 dividend in nonvoting common. However, the Government concedes, for the purpose of this case, that the statement in Finding 5 is correct.

[3] On the same day that it paid the $121,680.43 stock dividend, February 13, 1936, the corporation also paid a 6% cash dividend in the aggregate amount of $73,008.26, which was distributed among the holders of both classes of stock (R. 14).

$20,000 as his share of the distribution. (R. 15, 17, 23, 24.) Prior to the dividend, he did not own any nonvoting common. (R. 12, 21.) In his 1936 income tax returns, he did not report any income on account of that dividend. The Commissioner determined a deficiency by including the value of the stock dividend as income, and the Board of Tax Appeals sustained the determination.[4] (R. 19–33.) The Circuit Court of Appeals reversed, holding that the stock dividend could not constitutionally be subjected to tax if it were distributed to holders of both classes of outstanding stock in proportion to their stockholdings.

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

1. In holding that the stock dividend could not constitutionally be subjected to tax.

2. In holding that the nonvoting common stock which taxpayer received as a dividend upon his voting common stock was not income to the taxpayer.

3. In failing to hold that taxpayer realized income in the amount of the fair market value of

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[4] The corporation also paid a dividend in nonvoting preferred stock on its voting and on its nonvoting common stock in December 1936 (R. 14–15, 22). In this distribution taxpayer received preferred stock of a par and a market value of $22,300 (R. 15, 17, 23, 24). The Commissioner treated this stock dividend as taxable, and the Board also upheld this part of the Commissioner's determination. Upon appeal to the court below the taxpayer did not challenge this part of the Board's decision.

the shares of nonvoting common stock which he received as a stock dividend upon his shares of voting common stock.

4. In reversing the decision of the Board of Tax Appeals.

REASONS FOR GRANTING THE WRIT

1. The decision below rests upon *Eisner* v. *Macomber*, 252 U. S. 189, which held that Congress had no authority under the Constitution to impose a tax upon a dividend of common stock paid to the shareholders of a corporation which had only common stock outstanding. *Eisner* v. *Macomber* was decided by a sharply divided court, and established erroneous constitutional limitations upon the Federal taxing power. That decision has been a source of considerable confusion, and has stood with its sweeping exposition of the constitutional limits upon the taxing power as an obstacle to the formulation of sound revenue legislation. It is of public importance that *Eisner* v. *Macomber* be reexamined, not merely because of its erroneous ruling with respect to the taxation of stock dividends, but, more important, because of its restrictive effect upon tax law generally.

The basic power of Congress to levy taxes is conferred by Article I, Section 8, Clause 1 of the Constitution, which provides:

> The Congress shall have power to lay and collect taxes, duties, imposts, and excises, to pay the debts and provide for the common

> defense and general welfare of the United States; but all duties, imposts, and excises shall be uniform throughout the United States;

The authority so conferred "is exhaustive and embraces every conceivable power of taxation." *Brushaber* v. *Union Pac. R.R.*, 240 U. S. 1, 12. The Constitution itself imposes but three restrictions upon the exercise of that power: (1) duties, imposts, and excises must be uniform throughout the United States (Art. I, Sec. 8, cl. 1); (2) direct taxes must be apportioned among the states according to population (Art. I, Sec. 2, cl. 3, and Art. I, Sec. 9, cl. 4); and (3) no tax or duty may be laid upon exports (Art. I, Sec. 9, cl. 5).

Apart from the foregoing restrictions the power to tax is plenary. However, it was held in *Pollock* v. *Farmers' Loan & Trust Co.*, 157 U. S. 429, 158 U. S. 601, that a tax upon income from property is a direct tax, and is therefore invalid unless apportioned among the states according to population.

The Sixteenth Amendment to the Constitution was adopted in response to the *Pollock* decision, and provides:

> The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.

The Amendment was not intended as a limitation upon the taxing power. Rather, it was intended to *expand* the taxing power, giving full scope to Congressional power under Article I, unencumbered by the unworkable requirement of apportionment which the majority of the Court thought existed in the *Pollock* case with respect to certain types of income.

No one has ever doubted that stock dividends could be taxed under the plenary power granted by Article I, the only question being whether a tax upon stock dividends must be apportioned. We submit that whatever basis there may have been for the apportionment requirement has been removed by the Sixteenth Amendment which was intended "to get rid of nice questions as to what might be direct taxes" (Holmes J., dissenting in *Eisner* v. *Macomber*, 252 U. S. at 220).

The *Macomber* decision erroneously treats the Sixteenth Amendment as though it were the source of the taxing power and undertakes to measure the tax by what it conceives to be limitations imposed by the Amendment. It is a matter of great public importance that this Court clarify the scope of the taxing power so as to accord to Congress the full sweep of authority that was intended by Article I and the Sixteenth Amendment.

As frequently happens in the case of unsound decisions, the operative scope of *Eisner* v. *Macomber* has been considerably narrowed by subse-

quent decisions. See *United States* v. *Phellis*, 257 U. S. 156; *Rockefeller* v. *United States*, 257 U. S. 176; *Cullinan* v. *Walker*, 262 U. S. 134; *Marr* v. *United States*, 268 U. S. 536; *Koshland* v. *Helvering*, 298 U. S. 441; *Helvering* v. *Gowran*, 302 U. S. 238; *Helvering* v. *Braun*, 309 U. S. 461, 468. The process of increasing limitation upon *Eisner* v. *Macomber* has now reached the point where it has become exceedingly difficult to reconcile the basic theory of that case with the later expressions of this Court.

But the process of distinguishing *Eisner* v. *Macomber* has been an unsatisfactory method of dealing with the problem. The decision has continued to cast a restrictive influence upon the legislative development of an effective method for taxing corporate earnings; witness the undistributed profits

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Illustrative of the confusion produced by the *Macomber* case is the fact that Congress thereafter specifically exempted all stock dividends from tax, thinking that such sweeping exemption was constitutionally required by the decision. See *Koshland* v. *Helvering*, 298 U. S. at 444–445. It was not until after the *Koshland* decision, some fifteen or sixteen years after *Eisner* v. *Macomber*, that Congress, in Section 115 (f) of the Revenue Act of 1936 (see Appendix, *infra*), eliminated that exemption and substituted a provision which in effect makes taxability coextensive with constitutional powers, thereby throwing back upon the courts the question of how far the *Macomber* case goes.

tax under the Revenue Act of 1936.* And the present national emergency requires that Congress be free to develop fiscal policies unhampered by Constitutional limitations of such doubtful validity.

2. Even if *Eisner* v. *Macomber* be permitted to stand, the decision below conflicts in principle with *Koshland* v. *Helvering*, 298 U. S. 441. Underlying the *Koshland* decision was the holding that a distribution of a dividend in common stock to holders of preferred stock constituted taxable income in the hands of the recipients. The Court pointed out that "where a stock dividend gives the stockholder an interest different from that which his former stockholdings represented he receives income." 298 U. S. at 446. Applying that principle here, it is apparent that the respondent, who owned only voting stock prior to the dividend, thereafter became the owner of non-voting as well as voting

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*Compare the provisions of Section 337 of the Internal Revenue Code relating to foreign personal holding companies, where Congress has undertaken to tax corporate earnings directly to the stockholder in order to prevent avoidance. Conceivably, if Congress were freed of the restrictive effect of *Eisner* v. *Macomber*, it might adopt the same method of taxing earnings of domestic corporations. Cf. *Collector* v. *Hubbard*, 12 Wall. 1.

stock. There had been a readjustment of corporate structure, such that respondent could sell his non-voting stock and still retain the same control over the enterprise. The non-voting stock distributed to him represented corporate earnings, convertible into cash by sale without diminishing his basic interest any more than would have been the situation in the *Koshland* case had the stockholder sold the stock dividend.

3. The decision below is in conflict with the decision of the Circuit Court of Appeals for the Second Circuit in *Strassburger* v. *Commissioner of Internal Revenue*, decided December 22, 1941, not yet officially reported but which may be found in 1941 Prentice Hall, Vol. 4, Par. 63,103. There the owner of all the common stock of a corporation, which had only common stock outstanding, received a stock dividend of non-voting, cumulative, seven percent preferred stock. The Court held that the stock dividend was taxable. Although the facts in the two cases are not identical, there is an essential conflict in basic theory between the decisions. The difference between the courts stems from varying interpretations of the scope of the *Koshland* v. *Helvering* and *Eisner* v. *Macomber*. In the *Koshland* case this Court summarized the rules as follows (pp. 445–446):

> Under our decisions the payment of a dividend of new common shares, conferring no different rights or interests than did the old,—the new certificates, plus the old, repre-

> senting the same proportionate interest in the net assets of the corporation as did the old,—does not constitute the receipt of income by the stockholder. On the other hand, where a stock dividend gives the stockholder an interest different from that which his former stock holdings represented he receives income. * * *

It is to be noted that the tests laid down by these two sentences are not mutually exclusive since it is possible for a stock dividend to result in giving the stockholder an interest different from that which his former holdings represented and yet not change his proportionate interest in the net assets of the corporation. Both the instant case and the *Strassburger* case are examples of such a situation. The Second Circuit held in the *Strassburger* case that since the new stock represented interests different from those which the old stock represented it constituted income, even though the stockholder's fractional interest in the net assets of the corporation was not changed. In the instant case the court below stated that in its opinion the "real test" is "whether the distribution effects a change in the proportionate interests of the stockholders."

CONCLUSION

It is respectfully submitted that the within petition should be granted.

CHARLES FAHY,
Solicitor General.

JANUARY 1942.

APPENDIX

Constitution of the United States:

Article I, Section 2, clause 3:

Representatives and direct Taxes shall be apportioned among the several States which may be included within this Union, according to their respective Numbers, which shall be determined by adding to the whole Number of free Persons, including those bound to Service for a Term of Years, and excluding Indians not taxed, three-fifths of all other Persons * * *.

Article I, Section 8, clause 1:

The Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States * * *.

Article I, Section 9, clauses 4 and 5:

No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken.

No Tax or Duty shall be laid on Articles exported from any State.

* * * * *

Sixteenth Amendment:

The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from * * * dividends, * * *.

* * * * *

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this title * * * means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

(b) *Source of Distributions.*—For the purposes of this Act every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. * * *

* * * * *

(f) *Stock Dividends.*—

(1) *General Rule.*—A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution.

(2) *Election of shareholders as to medium of payment.*—Whenever a distribution by a

corporation is, at the election of any of the shareholders (whether exercised before or after the declaration thereof), payable either (A) in its stock or in rights to acquire its stock, of a class which if distributed without election would be exempt from tax under paragraph (1), or (B) in money or any other property (including its stock or in rights to acquire its stock, of a class which if distributed without election would not be exempt from tax under paragraph (1)), then the distribution shall constitute a taxable dividend in the hands of all shareholders, regardless of the medium in which paid.

* * * * * *

Treasury Regulations 94, relating to the Revenue Act of 1936:

ART. 115–4. *Stock dividends.*—A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall be treated as a dividend to the full extent that it constitutes income to the shareholders within the meaning of the sixteenth amendment to the Constitution. The Supreme Court has pointed out some of the characteristics distinguishing a stock dividend which constitutes income from one which does not constitute income within the meaning of the Constitution.[1] The distinction between a stock dividend which does not,

[1] See *Eisner* v. *Macomber* (252 U. S. 189, T. D. 3010, C. B. 3, 25); and *Koshland* v. *Helvering* (56 Sup. Ct. 767, Ct. D. 1124, C. B. XV–1, 219). Compare *United States* v. *Phellis* (257 U. S. 156, T. D. 3270, C. B. 5, 37); *Rockefeller* v. *United States* (257 U. S. 176, T. D. 3271, C. B. 5, 34); *Cullinan* v. *Walker* (262 U. S. 134, T. D. 3508, C. B. 11–2, 55); *Weiss* v. *Stearn* (265 U. S. 242, T. D. 3609, C. B. III–2, 51); and *Marr* v. *United States* (268 U. S. 536, T. D. 3755, C. B. IV–2, 116).

and one which does, constitute income to the shareholder within the meaning of the sixteenth amendment to the Constitution is the distinction between a stock dividend which works no change in the corporate entity, the same interest in the same corporation being represented after the distribution by more shares of precisely the same character, and a stock dividend where there either has been a change of corporate identity or a change in the nature of the shares issued as dividends whereby the proportional interest of the shareholder after the distribution is essentially different from his former interest. A stock dividend constitutes income if it gives the shareholder an interest different from that which his former stock holdings represented. A stock dividend does not constitute income if the new shares confer no different rights or interests than did the old—the new certificates plus the old representing the same proportionate interest in the net assets of the corporation as did the old.

Example (1): The X Corporation had an authorized capital stock of $300,000 of common stock, par value $10 a share, and $100,000 of 7 percent cumulative preferred stock, par value $100 a share, which is preferred as to dividends, has no voting rights, and may be redeemed at any time at $105 per share. The articles of incorporation provide that the annual dividend on the preferred stock may be paid in cash or, at the option of the corporation, in one share of common stock for each share of preferred. On July 1, 1936, the X Corporation had outstanding $200,000 of common stock and $100,000 of preferred stock, earnings and

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In the Supreme Court of the United States

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GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

R. A. SPROUSE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE PETITIONER

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BRIEF FOR THE PETITIONER

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 19–33) is reported in 42 B. T. A. 484. The opinion of the Circuit Court of Appeals (R. 50–54) is reported in 122 F. (2d) 973.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on October 22, 1941. (R. 55.) The petition for a writ of certiorari was filed on January 21, 1942, it was denied on March 2, 1942, and

a petition for rehearing was denied on March 30, 1942. On May 11, 1942, the order denying certiorari was vacated and the petition was granted. The jurisdiction of this Court rests upon Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the owner of voting common stock of a corporation realized taxable income upon the receipt of a stock dividend based upon corporate earnings and paid in nonvoting common stock of the corporation.

CONSTITUTIONAL PROVISIONS, STATUTE, AND REGULATIONS INVOLVED

The constitutional provisions, statute and regulations involved are set forth in the Appendix to the brief for the Government in *Strassburger* v. *Helvering*, No. 66, October Term, 1942.

STATEMENT

The facts, as stipulated (R. 12–19) and as found by the Board (R. 21–25), may be summarized as follows:

The respondent, R. A. Sprouse, was the owner of voting common stock in Sprouse-Reitz Company, Inc., an Oregon corporation, which, on February 13, 1936, paid a 10 per cent stock dividend in new shares of its nonvoting common stock. (R. 12, 14, 21, 22.) The corporation had

outstanding only two classes of stock, voting and nonvoting common stock having par values in the respective aggregate amounts of $397,471.25 and $819,333.06.[1] (R. 13, 21.) The stock dividend consisted of $121,680.43 par value nonvoting common stock which was distributed to the holders of both the voting and nonvoting common in proportion to their respective stockholdings.[2] (R. 14, 15, 22, 23.) The fair market value of the nonvoting common stock at the time of distribution was equal to its par value. (R. 15, 23.)

The earnings and profits of the corporation available for distribution at the time of the dividend were not less than $200,000.[3] (R. 15.)

The respondent received 200 shares of the nonvoting common stock having a fair market value

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[1] The corporation had authorized capital stock of $2,000,000, consisting of 6,000 shares of voting common, 12,000 shares of nonvoting common, and 2,000 shares of nonvoting preferred stock, the shares of each class having a par value of $100 each. (R. 13, 21.)

[2] Although Finding 5 (R. 23) states that the distribution was "in proportion" to the respective stockholdings of both classes, Finding 3 (R. 22) gives specific figures that are slightly at variance with that conclusion. Thus, pursuant to Finding 3, the voting common received a $40,333.34 dividend in nonvoting common and the nonvoting common received an $81,347.09 dividend in nonvoting common. However, the Government concedes, for the purposes of this case, that the statement in Finding 5 is correct.

[3] On the same day that it paid the $121,680.43 stock dividend, February 13, 1936, the corporation also paid a 6% cash dividend in the aggregate amount of $73,008.26, which was distributed among the holders of both classes of stock. (R. 14.)

of $20,000 as his share of the distribution. (R. 15, 17, 23, 24.) Prior to the dividend, he did not own any nonvoting common. (R. 17, 24.) In his 1936 income tax returns, he did not report any income on account of that dividend. The Commissioner determined a deficiency by including the value of the stock dividend as income, and the Board of Tax Appeals sustained the determination.[1] (R. 19–33.) The Circuit Court of Appeals reversed, holding that the stock dividend could not constitutionally be subjected to tax if it were distributed to holders of both classes of outstanding stock in proportion to their stockholdings. (R. 50–54.)

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

1. In holding that the stock dividend could not constitutionally be subjected to tax.

2. In holding that the nonvoting common stock which taxpayer received as a dividend upon his voting common stock was not income to the taxpayer.

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[1] The corporation also paid a dividend in nonvoting preferred stock on its voting and on its nonvoting common stock in December, 1936. (R. 14–15, 22.) In this distribution taxpayer received preferred stock of a par and a market value of $22,300. (R. 15, 17, 23, 24.) The Commissioner treated this stock dividend as taxable, and the Board also upheld this part of the Commissioner's determination. Upon appeal to the court below the taxpayer did not challenge this part of the Board's decision.

3. In failing to hold that taxpayer realized income in the amount of the fair market value of the shares of nonvoting common stock which he received as a stock dividend upon his shares of voting common stock.

4. In reversing the decision of the Board of Tax Appeals.

ARGUMENT

This case is a companion case to *Strassburger* v. *Helvering*, No. 66, and we respectfully refer the Court to our brief in that case for a full discussion of the issues involved. We contend that the stock dividend here involved was income to the respondent within the meaning of the Sixteenth Amendment, and taxable to him under the applicable provisions of the Revenue Act of 1936. To the extent that *Eisner* v. *Macomber*, 252 U. S. 189, holds to the contrary, we submit that it was erroneously decided and should now be overruled.

If, however, this Court should not overrule *Eisner* v. *Macomber* then we submit that the stock dividend *sub judice* was income to the respondent under *Koshland* v. *Helvering*, 298 U. S. 441, and *Helvering* v. *Gowran*, 302 U. S. 238. Cf. *Chapman* v. *United States*, 63 C. Cls. 106; certiorari denied, 275 U. S. 524, decided prior to the *Koshland* decision. Prior to the receipt of the stock dividend the respondent owned only voting stock, but the distribution of the stock dividend constituted a readjustment of the corporate structure

such that he could sell his nonvoting stock and still retain the same control over the enterprise. This new stock represented corporate earnings convertible into cash by sale without diminishing the respondent's basic interest any more than would have been the situation in the *Koshland* case had the stockholder there sold the stock dividend. Since the new stock represented an interest different in kind from that theretofore held by the respondent, it is immaterial that the dividend might not have affected his *proportionate* interest in the corporate assets. A cash dividend does not alter the stockholder's proportionate interest, and yet it is indisputably taxable as income; the result should not be different here.

CONCLUSION

The decision below is erroneous and should be reversed.

Respectfully submitted,

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OCTOBER, 1942.

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IN THE

Supreme Court of the United States

October Term, 1942

No. 22

GUY T. HELVERING
Commissioner of Internal Revenue
Petitioner
vs.
R. A. SPROUSE
Respondent

On Writ of Certiorari to the United States Circuit Court of Appeals for the Ninth Circuit

BRIEF FOR THE RESPONDENT

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IN THE

Supreme Court of the United States

October Term, 1942

No. 22

GUY T. HELVERING
Commissioner of Internal Revenue
Petitioner
vs.
R. A. SPROUSE
Respondent

On Writ of Certiorari to the United States Circuit Court of Appeals for the Ninth Circuit

BRIEF FOR THE RESPONDENT

Opinions Below

The opinion of the Board of Tax Appeals (R. 19-33) is reported in 42 B. T. A. 484. The opinion of the Circuit Court of Appeals (R. 50-54) is reported in 122 F. (2d) 973.

Jurisdiction

The judgment of the Circuit Court of Appeals was entered on October 22, 1941 (R. 55). The petition for a writ of certiorari was filed on January 21, 1942; it was denied on March 2, 1942, and a petition for rehearing was denied on March 30, 1942. On May 11, 1942, the order denying certiorari was vacated and the petition was granted. The jurisdiction of this Court rests upon Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

Question Presented

Whether the owner of voting common stock of a corporation, which had only voting common and nonvoting common stock outstanding, realized taxable income upon the receipt of a stock dividend based upon corporate earnings and paid in nonvoting common stock of the corporation.

Constitutional Provisions, Statute, and Regulations Involved

The constitutional provisions, statute, and regulations involved are set forth in the Appendix, infra, pp. 46-51.

Statement

The statement of the case in the petitioner's brief (Petitioner's Brief pp. 2-4) is correct[1] but should be amplified by certain additional facts as stipulated (R. 12-19) and as found by the Board (R. 21-25). These additional facts may be summarized as follows:

At the time of the payment of the stock dividend on February 13, 1936, the authorized capital stock of Sprouse-Reitz Co. Inc. consisted of three classes of shares: voting common stock, nonvoting common stock, and nonvoting seven per cent. preferred stock (R. 21, 22). Only voting common stock and nonvoting common stock were outstanding at that time, none of the authorized preferred stock having been issued (R. 21). The corporation's articles of incorporation contained the following provision (R. 22):

> "The preferred stock shall be entitled to a dividend of 7 percent annually upon the par value before any dividends are paid on either class of the common stock. The common stock shall be entitled to dividends equally on each class thereof after the dividends on the preferred stock are paid.

[1] Petitioner has called attention to a slight variance between Finding 5 (R. 23) and Finding 3 (R. 22) (Pet. Br. p. 3, ftn. 2). Finding 5 was correct. The distribution of nonvoting common stock was in proportion to the respective stockholdings of both classes. Through inadvertent error the specific figures used in Finding 3 were incorrect.

The preferred stock and the nonvoting common stock shall have no voting power. The preferred stock shall be made redeemable at any time after three years from the date of its issue, in the discretion of the board of directors, but such redemption shall be at par, and after all accrued dividends have been paid. In the event of liquidation or dissolution of the corporation all classes of stock shall share equally in the assets."

SUMMARY OF ARGUMENT

I

The stock dividend in this case is not taxable under the rule of *Eisner v. Macomber* as affirmed by *Koshland v. Helvering* and *Helvering v. Gowran.*

A. This Court held in *Eisner v. Macomber*, 252 U. S. 189, that appreciation in the value of a capital asset was not income; that there must also be some change in the form or extent of the investment; and that a stock dividend which did not alter the stockholder's pre-existing interest in the corporation did not constitute income.

B. The basic doctrine of *Eisner v. Macomber* was affirmed by this Court in later cases involving the taxability of stock dividends. *Koshland v. Helvering*, 298 U. S. 44; *Helvering v. Gowran*, 302 U. S. 238.

Under that basic doctrine the stock dividend received by the respondent in the instant case was not income since it left his pre-existing interest in the corporation unchanged.

II

Eisner v. Macomber was correctly decided. Stock dividends which do not change the form or extent of the taxpayer's investment do not constitute income.

A. The question presented by the instant case is whether the stock dividend received by the respondent constituted income within the meaning of the Sixteenth Amendment. The Sixteenth Amendment authorizes an unapportioned tax only on what is actually income. If the stock dividend here involved was not income under the Sixteenth Amendment, it was not taxable under Section 115 (f) (1) of the Revenue Act of 1936.

B. The holding of the *Macomber* case that to constitute income a stock dividend must change the form or extent of the stockholder's interest has been tested and approved by this Court in subsequent cases rather than repudiated as the petitioner asserts.

C. The concept of income developed in *Eisner v. Macomber* is logically sound and contributes to efficient administration of the income tax laws.

III

In amending Section 115 (f) Congress intended to exempt from tax stock dividends of the type involved in the present case and in *Eisner v. Macomber*.

A. Where a question exists as to the proper construction of a statute, the Courts will if possible adopt that construction which will avoid a substantial constitutional question.

B. The circumstances surrounding the enactment of Section 115 (f) (1) of the Revenue Act of 1936 disclose that Congress did not intend to tax stock dividends of the type involved in the *Macomber* case and in the present case. Correctly construed to give effect to this congressional intent, Section 115 (f) (1) exempts from tax the stock dividend here involved. There is no occasion, therefore, for this Court to consider or decide the grave constitutional questions raised by the petitioner.

C. Even if petitioner's argument that *Eisner v. Macomber* is erroneous be conceded, the original intent of Congress in enacting Section 115 (f) (1) must still be given effect and stock dividends like that in the case at bar held to be nontaxable.

ARGUMENT

I

The stock dividend in this case is not taxable under the doctrine of Eisner v. Macomber, as affirmed by Koshland v. Helvering and Helvering v. Gowran.

The question of the taxability of stock dividends under an income tax statute has been directly before this Court in four cases during the past twenty-two years: *Eisner v. Macomber*, 252 U. S. 189; *Koshland v. Helvering*, 298 U. S. 441; *Helvering v. Gowran*, 302 U. S. 238; and *Helvering v. Pfeiffer*, 302 U. S. 247. The Circuit Court of Appeals correctly held that under the rule of those decisions the stock dividend in the instant case was not taxable to the respondent.

In *Eisner v. Macomber*, supra, this Court held that a dividend of voting common stock distributed on voting common stock did not constitute "income" to the recipient and could not be taxed under the applicable income tax law. The basic reasoning of the majority opinion is that mere increase in value of an investment in corporate stock is not converted into income by the distribution of a stock dividend which does not alter the stockholder's pre-existing proportional interest in the corporation. *Eisner v. Macomber*, pp. 211, 212.

The test announced in *Eisner v. Macomber* was not repudiated in *Koshland v. Helvering*, 298 U. S. 441, nor in *Helvering v. Gowran*, 302 U. S. 238, and *Helvering v. Pfeiffer*, 302 U. S. 247; it was merely rephrased and somewhat refined. In *Koshland v. Helvering*, supra, this Court, after referring to the broad interpretation placed on the *Macomber* case by the Treasury Department and to a provision in the Revenue Act of 1921 exempting all stock dividends from tax, said (p. 445):

> "Soon after the passage of that act, this court pointed out the distinction between a stock dividend which worked no change in the corporate entity, the same interest in the same corporation being represented after the distribution by more shares of precisely the same character, and such a dividend where there had either been changes of corporate identity or a change in the nature of the shares issued as dividends whereby the proportional interest of the stockholder after the distribution was essentially different from his former interest."

In a subsequent portion of the opinion the same idea was more affirmatively expressed as follows (pp. 445, 446):

> "Under our decisions the payment of a dividend of new common shares, conferring no different rights or interests than did the old, the new cer-

tificates, plus the old, representing the same proportionate interest in the net assets of the corporation as did the old, does not constitute the receipt of income by the stockholder. On the other hand, where a stock dividend gives the stockholder an interest different from that which his former stock holdings represented he receives income. The latter type of dividend is taxable as income under the Sixteenth Amendment. Whether Congress has taxed it as of the time of its receipt, is immaterial for present purposes."

It will be noted that the opinion in the *Koshland* case carefully points out that not all stock dividends constitute income, and states particularly that a dividend in common shares is not income where it does not alter the stockholder's "proportionate interest in the net assets of the corporation." The requirements for a nontaxable stock dividend as thus stated are met by the dividend here involved.

When the stock dividend in the instant case was declared, the corporation had outstanding only voting common and nonvoting common stock (R. 22). Each of these classes of common stock was equally entitled to regular dividends and likewise shared equally in the net assets of the corporation on liquidation (R. 22). The stock dividend in question was in nonvoting common stock distributed ratably to holders of voting common and nonvoting common shares (R. 23).

Obviously, under these conditions the distribution to the respondent of nonvoting common shares as a dividend on his voting common stock did not confer on him any new or different rights and did not alter the nature or extent of his interest in the corporation. Since the dividend was paid ratably to all stockholders, it did not disturb in the slightest degree the relationship previously existing among those stockholders, or the relationship previously existing between the respondent and the corporation. After the distribution of the dividend shares the respondent was entitled to the same number of votes, to the same proportion of the total votes, to the same proportionate share of regular dividends, and to the same actual and proportionate participation in liquidating dividends as he was entitled to prior to his receipt of the nonvoting shares.

The dividend changed neither the kind nor quantity of the respondent's interest in the corporation; in effect, his former property interest was simply restated. The position of the respondent in relation to the corporation and to the other stockholders immediately following the payment of the stock dividend in nonvoting common stock cannot be distinguished from the position of the taxpayer Macomber after her receipt of the stock dividend held nontaxable in *Eisner v. Macomber*, supra.

The petitioner asserts that the stock dividend here involved was income to the respondent under *Koshland v. Helvering*, supra, because "the new stock represented an interest different in kind from that theretofore held by the respondent" (Pet. Br. p. 6). But this argument misinterprets the *Koshland* decision. The opinion in that case does not say that *any* change in the nature of the shares issued as dividends will render the stock dividend taxable to the recipient. To make the dividend taxable, there must be "a change in the nature of the shares issued as dividends *whereby the proportional interest of the stockholder after the distribution was essentially different from his former interest.*" *Koshland v. Helvering*, supra, p. 445. (Italics supplied)

As shown above, the dividend paid to the respondent in nonvoting common shares did not change the extent of his interest in the corporation or work any change in his entire capital interest in the corporate enterprise. This case falls squarely within the statement in the *Koshland* opinion that "the payment of a dividend of new common shares, conferring no different rights or interests than did the old, the new certificates, plus the old, representing the same proportionate interest in the net assets of the corporation

as did the old, does not constitute the receipt of income by the stockholder." *Koshland v. Helvering*, supra, p. 446.

II

Eisner v. Macomber was correctly decided. Stock dividends which do not change the form or extent of the stockholder's investment do not constitute income.

The petitioner's brief in this case charges that *Eisner v. Macomber*, supra, was erroneously decided and should be overruled. For a discussion of this issue petitioner refers the Court to his answering brief in *Strassburger v. Helvering*, No. 66, in which he has inserted a lengthy argument dealing generally with the power to tax granted Congress by the Constitution.

We submit, however, that even if this Court should conclude to re-examine its long-standing decision in *Eisner v. Macomber*, that re-examination would not properly involve a review of the broad constitutional questions posed by the petitioner's answering brief in the *Strassburger* case. (Strassburger Br. pp. 14-23.) So far as the present case provides a vehicle for the

For convenience, the brief of the Commissioner of Internal Revenue in *Strassburger v. Helvering*, No. 66, will be cited herein as "Strassburger Br."

re-examination of *Eisner v. Macomber*, it does so by presenting a problem of statutory construction. The statutory provision in question is Section 115 (f) (1) of the Revenue Act of 1936, which provides:

> "A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution."

Clearly, this section turns us back to the meaning of the term "income" in the Sixteenth Amendment. The petitioner, acting on the erroneous assumption that the section makes taxability co-extensive with constitutional power (Strassburger Br. p. 11), has attempted to go further and to explore the larger question of the constitutional power of Congress to tax stock dividends without reference to their status as income. (Strassburger Br. pp. 14-23.) We are not here concerned with that question. It is in no way involved in this case.

In *Pollock v. Farmers Loan & Trust Co.*, 158 U. S. 601 (1895), this Court held that taxes upon real or personal property or upon the income derived from

such property were direct taxes and invalid unless apportioned as required by Article I, Section 9, Clause 4 of the Constitution. The Sixteenth Amendment eliminated the requirement of apportionment only with respect to federal taxes on incomes and left unchanged the holding of the *Pollock* case that a tax on real or personal property must be apportioned. *Brushaber v. Union Pacific Railroad Company*, 240 U. S. 1, 17-19; *Stanton v. Baltic Mining Company*, 240 U. S. 103, 112; *Peck & Co. v. Lowe*, 247 U. S. 165, 172, 173; *Eisner v. Macomber*, 252 U. S. 189, 206. It follows that the power of Congress under the Sixteenth Amendment to impose an unapportioned tax is confined to the taxation of "income" in the proper sense, and does not extend to income enlarged by artificial definitions to include what is not in fact income.

The statutory provision, Section 115 (f) (1), *supra*, under which the petitioner seeks to impose a tax on the stock dividend received by the respondent.

While the *Pollock* case directly involved only a tax on incomes, the majority opinion clearly set forth the basic proposition that taxes on real or personal property are direct. See 158 U. S. 601 at 618, 628, 629, 634. Compare Mr. Justice Jackson's dissent in 158 U. S. 601 at 696. See also majority opinion in first *Pollock* case, 157 U. S. 429, 574.

is a part of the Income Tax Title[1] of the Revenue Act of 1936. Moreover, Section 115 (f) (1) refers expressly to stock dividends which constitute "income" within the meaning of the Sixteenth Amendment. The sole question involved in petitioner's attack on *Eisner v. Macomber* is, therefore, whether the stock dividend received by the respondent is "income" under the Sixteenth Amendment.

Both the majority opinion and the minority opinion[2] in *Eisner v. Macomber*, supra, seem to recognize that Congress may not exceed the bounds of the power conferred by the Sixteenth Amendment and define as income that which does not in fact constitute income. The disagreement within the Court in the *Macomber* case was not with respect to the issue to be resolved. All were agreed that the question was whether a stock dividend constituted income. The divergence between the prevailing and dissenting opinions was only as to the correct answer to that question. In answering the question in the negative,

[1] Title I of the Revenue Act of 1936, c. 690, 49 Stat. 1652, is headed "Income Tax." Section 115 (f) (1) is under this heading: c. 690, 49 Stat. 1688.

[2] 252 U. S. 189, at 219.

[3] 252 U. S. 189, at 225.

the majority opinion by Mr. Justice Pitney adopts the view that mere appreciation in value of corporate stock is not income to the shareholder until realized through some change in the form or extent of his interest in the corporation.

On this question of whether a stock dividend of the *Macomber* type represents income, the petitioner argues that this Court has held in *Collector v. Hubbard*, 12 Wall. 1, that Congress has power to tax a stockholder on his proportionate interest in the undivided corporate earnings as they accrue. (Strassburger Br. pp. 25-30.) From this he concludes that the receipt by a stockholder of a stock dividend representing those earnings must constitute taxable income to the shareholder. (Strassburger Br. p. 25.) We believe that petitioner's interpretation and application of the *Hubbard* case is erroneous.

The case of *Collector v. Hubbard*, supra, arose under the Internal Revenue Act of 1864, which provided that the gains or profits of certain companies should be included in estimating the annual gains, profits or income of any person entitled to the same, whether divided or otherwise. The object of this provision was to insure the payment of a tax upon the

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c. 173, 13 Stat. 223, 281.

earnings of the corporation (See *Gibbons v. Mahon*, 136 U. S. 549, 560), since the tax thus levied on the shareholders was the only tax imposed with respect to corporate earnings.

In the *Hubbard* case, which was decided twenty-five years before *Pollock v. Farmers Loan & Trust Co.*, supra, no question was raised of the constitutional power of Congress to tax incomes or property. Accordingly, the Court found it unnecessary to determine the nature of the increase in the value of a shareholder's stock attributable to his interest in the undivided corporate profits and merely held that such profits were property and were taxable. *Collector v. Hubbard*, supra, at 18.

On the other hand, the holding in the *Pollock* case, the language of Section 115(f) (1), and the language of the Sixteenth Amendment all make it necessary to distinguish in the case at bar between a tax on income and a direct tax on the capital investment of the stockholder. Further, the tax statute in the *Hubbard* case is so fundamentally different from the provisions of the Revenue Act of 1936 applicable to the present case that the *Hubbard* decision becomes irrelevant. As noted above, the Act of 1864 imposed no tax on corporations but merely attempted to reach

corporate earnings by taxing them to the shareholders when they accrued. The Revenue Act of 1936, however, far from disregarding the corporate entity for tax purposes, makes that entity a basic part of the income tax structure by taxing corporations directly on their incomes.[7] It is a contradiction of the terms of the statute to regard the corporate earnings as being income to two taxpayers—the corporation and its shareholders—simultaneously.[8] So far as a stockholder is concerned, the earnings merely represent an increase in the value of his capital investment and do not become realized income to him until there is a change in the form or extent of that investment.

The petitioner also sharply challenges the reasoning of the majority opinion in *Eisner v. Macomber*.

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[7] See Sections 13 and 14, Revenue Act of 1936, c. 690, 49 Stat. 1648, 1655.

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[8] See Powell, Stock Dividends (1920), 20 Col. L. Rev. 536, 542. The entire plan of the taxing statute refutes the theory that the same earnings are taxable to two taxpayers as they accrue. Under the partnership provisions of the 1936 Act, for example, no tax is levied on the partnership income as such. The partnership is merely regarded as an accounting entity the income of which is to be computed and taxed to the individual partners, whether distributed or not. See Sections 181, 182, 183, Revenue Act of 1936, c. 690, 49 Stat. 1648, 1709. This treatment of partnerships for tax purposes is the basis of this Court's decision in Heiner v. Mellon, 304 U. S. 271, 281, cited by petitioner (Strassburger Br. p. 26).

(Strassburger Br. pp. 31-41.) He asserts that such later decisions of this Court as *Koshland v. Helvering*, supra; *United States v. Phellis*, 257 U. S. 156; *Rockefeller v. United States*, 257 U. S. 176; *Cullinan v. Walker*, 262 U. S. 134; *Weiss v. Stearn*, 265 U. S. 242; and *Marr v. United States*, 268 U. S. 536 (1925), have repudiated the rationale of the *Macomber* decision. (Strassburger Br. pp. 31, 32.) The fact is that in all of the cases just mentioned this Court expressly considered the doctrine of the *Macomber* case and in some degree restricted its scope. But in each of these decisions the Court confirmed and left intact the fundamental rule that a stockholder does not realize income upon receipt of a stock dividend which does not change his interest in the corporation.

As recently as 1936, in the *Koshland* case, this Court has said that the test in determining the taxability of stock dividends is whether it changes the proportionate interest of the stockholder in the corporation. *Koshland v. Helvering*, supra, p. 445. As shown in the first portion of this brief, supra, p. 11, this test clearly affirms the nontaxable character of the stock dividend in *Eisner v. Macomber* and likewise of the stock dividend involved in the present case.

The five remaining cases listed above involved corporate reorganizations and in each of them the rationale of *Eisner v. Macomber* was subjected to searching scrutiny. In *Marr v. United States*, supra, the last of these cases in point of time, the prevailing opinion of Mr. Justice Brandeis represents a crystallization of the conclusions which the Court had been evolving in the preceding cases. The majority opinion in *Marr v. United States*, supra, states in part (pp. 540, 542):

> "In each of the five cases named, as in the case at bar, the business enterprise actually conducted remained exactly the same. In United States v. Phellis, in Rockefeller v. United States, and in Cullinan v. Walker, where the additional value in new securities distributed was held to be taxable as income, there had been changes of corporate identity . . . In Eisner v. Macomber and in Weiss v. Stearn, where the additional value in new securities was held not to be taxable, the identity was deemed to have been preserved . . .
>
> In the case at bar, the new corporation is essentially different from the old . . . The case at bar is not one in which after the distribution the stockholders have the same proportional interest of the same kind in essentially the same corporation."

The net result of these reorganization cases was to re-examine and clarify the doctrine of *Eisner v. Macomber* by testing it against varying fact situations.

Thus, this Court found that the test prescribed by the *Macomber* case was not met in the *Phellis, Rockefeller, Cullinan,* and *Marr* cases because the dividend in each of those cases resulted in a change in the kind or extent of the interest of the shareholder. In *Weiss v. Stearn*, supra, the *Macomber* test was held to be satisfied because of the substantial identity of the stockholder's interest before and after the distribution of the dividend shares. In each of these decisions[10] the Court gave careful consideration to the validity of the *Macomber* case and approved the basic doctrine of the majority opinion in that case. There is therefore no substance in the petitioner's assertion that the cases discussed above have repudiated the majority opinion in *Eisner v. Macomber.*

The petitioner next contends that *Eisner v. Macomber* erroneously holds that there can be no income unless it is "severed from" capital. (Strassburger Br. pp. 34-39.) It is apparent, however, that this requirement of "severability" is merely another way of saying that appreciation in the value of corporate stock is not income to the stockholder until it is

[10] *United States v. Phellis*, 257 U. S. 156 at 169, 170, 175; *Cullinan v. Walker*, 262 U. S. 134 at 137; *Marr v. United States*, 268 U. S. 536 at 540; *Weiss v. Stearn*, 265 U. S. 242 at 253, 254; *Rockefeller v. United States*, 257 U. S. 176 at 183, 184, decided on authority of *U. S. v. Phellis*, supra.

realized."[11] Under the *Macomber* case doctrine realization requires that the stockholder receive something distinct and different from his original investment.[12] Thus, a stock dividend which works no change in the form or extent of his investment—i.e., does not alter his proportional interest in the corporate assets—does not constitute income.

Correctly viewed, therefore, the "severability" requirement of the *Macomber* case has not been destroyed by subsequent decisions of this Court, such as those holding that the satisfaction of indebtedness for less than par may result in taxable income to the debtor. (Strassburger Br. p. 36.) The *Macomber* case was concerned with appreciation in the value of a capital asset. A majority of the Court found that the appreciation did not constitute income until there was some change in the form or extent of the taxpayer's interest. In cases such as *United States v. Kirby Lumber Company*, 284 U. S. 1 (1931), and *Helvering v. American Chicle Company*, 291 U. S. 426 (1934) (Strassburger Br, pp. 36-37), the satisfaction of obligations at less than par was itself an

[11] See the discussion of *Eisner v. Macomber* in Magill, Taxable Income (1936), p. 40.

[12] See 252 U. S. 189 at 209, 211.

income-producing transaction and thus could properly be found to result in taxable income to the debtor. In the *Kirby Lumber Company* case, supra, this feature of the transaction was noted by Mr. Justice Holmes in the following statement (284 U. S. at p. 3):

> "Here there was no shrinkage of assets and the taxpayer made a clear gain. As a result of its dealings it made available $137,521.30 assets previously offset by the obligation of bonds now extinct."

Similar income-producing transactions are present in the other examples cited by the petitioner, including the payment of a taxpayer's taxes and other obligations by a third person or the discharge of a mere "social duty." (Strassburger Br. p. 36.) To the extent that there is involved in these cases any appreciation in the value of a capital investment, the appreciation is a direct consequence of an event which produces income. On the other hand, the petitioner has stated directly that the "declaration of a stock dividend is not an income-producing transaction." (Strassburger Br. p. 7.) Because of this complete lack of analogy, we submit that these cases are not pertinent to a discussion of the soundness of the majority opinion in *Eisner v. Macomber.*

The petitioner relies most strongly in this portion of his argument upon *Helvering v. Bruun*, 309 U. S. 461, in which this Court held that upon repossession of leased premises after default, a lessor realized income to the extent of the value of a building erected on the land by the tenant. (Strassburger Br. pp. 37-38.) It is obvious that in this case the building represented an increase in the value of the lessor's land, but it is likewise clear that under the *Eisner v. Macomber* test the appreciation in value was "realized" by the lessor when he recovered the premises on default.

Prior to his repossession the lessor's interest was that of owner of the land and building, subject to the leasehold. After repossession, his interest was that of owner in fee simple. Thus he realized income under the *Macomber* test when he recovered the premises because the repossession changed both the form and extent of his pre-existing interest. Indeed, the opinion of this Court in the *Bruun* case indicates that this distinction was in the Court's mind; for the attempt of the taxpayer Bruun to rely on a supposed analogy with the stock dividend cases was dismissed with the following statement (pp. 468-469):

> "These expressions, however, were used to clarify the distinction between an ordinary dividend

and a stock dividend. They were meant to show that in the case of a stock dividend, the stockholder's interest in the corporate assets after receipt of the dividend was the same as and inseverable from that which he owned before the dividend was declared. We think they are not controlling here."

In the final portion of his attack on *Eisner v. Macomber* the petitioner criticizes the "misconception" that a stock dividend does not constitute "income" because the stockholder's position after the dividend was the same as before. (Strassburger Br, p. 39.) The discussion in the foregoing paragraphs constitutes in large measure an answer to this portion of petitioner's brief.

It was clearly the opinion of the majority of this Court in *Eisner v. Macomber* that the mere appreciation in the value of an investment does not constitute income,[11] but that there must also be some change

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[11] See Mr. Justice Pitney's statement that "enrichment through increase in value of capital investment is not income in any proper meaning of the term." 252 U. S. 189 at 214, 215.

This Court reached a similar conclusion under the Income Tax Law of 1867, c. 139, 14 Stat. 478. Thus, in *Gray v. Darlington*, 15 Wall. 63, it was said (p. 66):

> "The mere fact that property has advanced in value between the date of its acquisition and sale does not authorize the imposition of a tax on the amount of the advance. Mere advance in value in no sense constitutes the gains, profits or income specified by the statute. It constitutes and can be treated merely as increase of capital."

See also *Lynch v. Turrish*, 247 U. S. 221, 230 (1918).

in the form or extent of the taxpayer's investment. Applying these concepts, this Court held that a stock dividend which does not alter the stockholder's interest in the corporation was not income. It should be noted that the same test would not exempt cash dividends from tax, as the petitioner implies. (Pet. Br. p. 6; Strassburger Br. p. 46.) The payment of a cash dividend unmistakably changes the form and extent of a taxpayer's investment, and under the *Macomber* rule constitutes income to him.

It is a fair deduction from the several opinions in *Eisner v. Macomber* that the majority and minority groups of the Court agreed that income must be "realized." Their disagreement went to the question whether a stock dividend which worked no change in the stockholder's pre-existing interest constituted "realization" of the increase in the value of his investment. Compare 252 U. S. 189 at 211 with 252 U. S. 189 at 229, 230. The holding of the majority was that a stockholder does not realize income unless the stock dividend alters the form or extent of his interest in the corporation.

Stated in more general terms, the doctrine of *Eisner v. Macomber* makes the determination of whether income is realized from the increase in value of a

capital asset depend on whether there has been any change in the form or extent of the taxpayer's interest in the asset. The result of applying the doctrine is to draw a line on one side of which income is said to be realized and on the other side of which the increase is said to remain capital. The validity of the doctrine may be tested therefore by examining the justification for drawing the line at this point.

From the standpoint of fundamental concepts of income the rule adopted by a majority of this Court in the *Macomber* case rests on a solid logical foundation. In distinguishing between capital and income, Justice Pitney in the prevailing opinion regards as capital the entire investment of the stockholder, including any increase in the value of that investment.[14] A stock dividend which works no change in the form or extent of the stockholder's investment, but merely restates it, does not alter the essential character of the stockholder's interest in the corporation. The increase in value is still capital. There has been no "realiza-

[14] See his statement at 252 U. S. 206, 207, that—

"The fundamental relation of 'capital' to 'income' has been much discussed by economists, the former being likened to the tree or the land, the latter to the fruit or the crop; the former depicted as a reservoir supplied from springs, the latter as the outlet stream, to be measured by its flow during a period of time . . ."

tion." Therefore, a stock dividend of this type is not reached by a tax on "income."[15]

The petitioner asserts, however, that the problem of "realization" is "one of finding an appropriate time for the measurement of an increase in wealth." (Strassburger Br. p. 38.) In other words, an increase in the value of a capital asset should be regarded as income at any time when the taxing authority believes it can be appropriately and conveniently measured. (Strassburger Br. p. 38.) The result of such a rule would be to discard the fundamental concepts on which *Eisner v. Macomber* is based and to substitute therefore a test of administrative convenience.

If the petitioner's suggestion were adopted and the existence of income, and the time when it should be taxed, made to depend on administrative convenience rather than on the *Macomber* doctrine of realization,

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[15] See *Merchants' Loan & Trust Co. v. Smietanka*, 255 U. S. 509, 520 (1921), where the Court in sustaining an income tax on capital gain from the sale of property, referred to "that 'realized gain' which has been repeatedly declared to be taxable income within the meaning of the constitutional amendment and the Acts of Congress."

[16] See *Commissioners of Inland Revenue v. Blott*, 2 A. C. 171 (1921), in which the House of Lords arrived at a similar conclusion under the British Finance Act (1909-10) 1910 (10 Edw. 7, c. 8). Several of the judges in the House of Lords referred approvingly to Mr. Justice Pitney's "most interesting and instructive judgment" in *Eisner v. Macomber*.

confusion and uncertainty would be introduced into the income tax law. On the other hand, the holding in *Eisner v. Macomber*, in addition to being based on a sound concept of income, has contributed to the efficient operation of the federal income tax system. Where a capital asset has increased in value, that increase becomes realized income[17] under the *Macomber* test only when there has been a change in the form or extent of the taxpayer's interest in the asset. Thus, taxpayers and tax authorities alike can easily determine the moment of realization under the test.[18] To the taxpayer the doctrine gives the advantage of stability and certainty and to the tax collector the advantage of easy administration.

We submit that the holding of the majority of this Court in *Eisner v. Macomber* was correct: that appreciation in the value of a stockholder's capital investment in a corporation is not income; and that a stock dividend which does not change but merely restates that investment is likewise not income.

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[17] See the conclusion of Powell in Constitutional Aspects of Income Taxation, The Federal Income Tax (1921), p. 82, that "'Realized gain' is a pretty sensible definition of income for a practical man, however it may seem to an expert conceptualist."

[18] Magill, Taxable Income (1936), pp. 66, 67.

III

In enacting Section 115 (f) (1) of the Revenue Act of 1936 Congress did not intend to tax stock dividends of the type involved in Eisner v. Macomber and in the case at bar.

The petitioner has devoted the greater part of his brief in the *Strassburger* case to an attack on the decision of this Court in *Eisner v. Macomber* and has requested that Congress be declared to have the constitutional power to tax all stock dividends. (Strassburger Br. pp. 21, 22.) In making this argument he has assumed that if *Eisner v. Macomber* is overruled the stock dividend in the case at bar would automatically become subject to tax under the Revenue Act of 1936.

We submit that a decision in the present case does not require such drastic measures as overruling a long-standing decision of this Court or re-examining the vexed constitutional questions which the petitioner propounds. It is the settled practice of this Court in all cases involving the construction of statutes to adopt, if reasonably possible, that construction which will avoid raising a grave constitutional question. *Shwab v. Doyle*, 258 U. S. 529 (1922); *Missouri Pac. R. Co. v. Boone*, 270 U. S. 466 (1926); *United States v. Delaware and Hudson Company*, 213 U. S. 366 (1909). The principle is stated by Mr. Justice

White in the *Delaware and Hudson* case as follows (p. 408):

> "It is elementary when the constitutionality of a statute is assailed, if the statute be reasonably susceptible of two interpretations, by one of which it would be unconstitutional and by the other valid, it is our plain duty to adopt that construction which will save the statute from constitutional infirmity. Knights Templars' & M. Life Indemnity Co. v. Jarman, 187 U. S. 197, 205, 47 L. ed. 139, 145, 23 Sup. Ct. Rep. 108. And unless this rule be considered as meaning that our duty is to first decide that a statute is unconstitutional, and then proceed to hold that such ruling was unnecessary because the statute is susceptible of a meaning which causes it not to be repugnant to the Constitution, the rule plainly must mean that where a statute is susceptible of two constructions, by one of which grave and doubtful constitutional questions arise and by the other of which such questions are avoided, our duty is to adopt the latter. Harriman v. Interstate Commerce Commission, 211 U. S. 407, 53 L. ed. ..... 29 Sup. Ct. Rep. 115."

This rule is particularly applicable in the instant case. The question of the constitutional power of Congress to tax the stock dividend here involved does not arise unless it is first found that in enacting the applicable provision of the Revenue Act of 1936 Congress did in fact intend to tax dividends of the type received by the respondent Sprouse. Thus, the pri-

mary issue in this case is not one of constitutional law but of statutory construction. Cf. *Towne v. Eisner*, 245 U. S. 418 (1918). We submit that it is reasonably open to this Court to find, and that therefore under the principle expressed in the *Delaware & Hudson* case it should find, that Congress at the time it amended Section 115(f) did not regard stock dividends of the *Macomber* type as income and that it enacted the amended section with the understanding that such dividends would not be taxed.

If this was the legislative intent, there is no occasion for the Court to take up the larger constitutional issues which petitioner seeks to raise. Whether the stock dividend here involved is income or, if not income, whether it can be taxed without apportionment, are questions which do not become relevant unless Congress has sought to subject it to tax.

The principle is firmly established that in construing a statute the Court will look to the circumstances surrounding its enactment and the particular evils at which it was aimed. *Apex Hosiery Co. v. Leader*, 310 U. S. 469 (1940); *Holy Trinity Church v. United States*, 143 U. S. 457 (1892). When Section 115 (f) (1) of the Revenue Act of 1936 is examined in the light of its legislative and judicial back-

ground, it is abundantly clear that Congress did not intend to tax stock dividends of the type involved in this case.

Prior to the decision of this Court in *Koshland v. Helvering*, supra, Congress had interpreted the holding in *Eisner v. Macomber* to mean that stock dividends, of whatever nature, were constitutionally exempt from taxation as income, and the Revenue Acts from 1921 through 1934 had expressly exempted all stock dividends from tax.[19] In the *Koshland* case, this Court held that the *Macomber* case had been given a broader interpretation than the actual decision warranted and that the test for determining the taxability of stock dividends was whether the proportionate interest of the stockholders after the distribution was essentially different from what it had been before.

As we have shown in an earlier portion of this brief, supra, p. 8, the *Macomber* case was not overruled by *Koshland v. Helvering*. In fact, the basic doctrine of the decision itself was reaffirmed, for the

[19] Revenue Act of 1921, c. 136, 42 Stat. 227, Section 201(d); Revenue Act of 1924, c. 234, 43 Stat. 253, Section 201 (f); Revenue Act of 1926, c. 27, 44 Stat. 9, Section 201 (f); Revenue Act of 1928, c. 852, 45 Stat. 791, Section 115 (f); Revenue Act of 1932, c. 209, 47 Stat. 169, Section 115 (f); Revenue Act of 1934, c. 277, 48 Stat. 680, Section 115 (f).

Court expressly recognized that the payment of a stock dividend of the type involved in the *Macomber* case did not constitute income within the meaning of the Sixteenth Amendment. *Koshland v. Helvering*, supra, at 445.

With the decisions of this Court in the *Macomber* and *Koshland* cases before it, Congress in enacting the Revenue Act of 1936 sought to impose an income tax on stock dividends to the extent permitted by the judicial definition of "income" in those cases. The provision in the prior Revenue Acts exempting all stock dividends from tax was eliminated; but in recognition of the limitations laid down in the *Macomber* case and redefined in the *Koshland* decision, Congress provided, in Section 115 (f) (1), that a stock dividend should not be taxable "to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment."

It is apparent from the very wording of Section 115(f) (1) that Congress considered some stock dividends to be nontaxable. Had Congress intended to reach all stock dividends of whatever kind, the obvious way for it to express that purpose would have been simply to strike out the exemption contained in the earlier Act; or it could have restored the provision which appeared prior to the *Macomber* case specifically declaring all stock dividends to be taxable. Instead, Congress carefully added an exception

to the general definition of income contained in Section 22(a) by providing that a distribution in stock to a corporation's shareholders "shall *not* be treated as a dividend to the extent that," etc. There is significance in the fact that Congress phrased this provision in the negative, thereby emphasizing that it was restrictive and that it was intended to exclude certain types of dividends from the operation of Section 22(a). The provision was originally drafted in the affirmative but was deliberately rephrased "in the interest of greater clarity".[20] (Sen. Rept. 2156, pp. 18-

[20]Petitioner seeks to attribute this rephrasing to changes occasioned by the amendment of Section 115(a) in the Senate. (Strassburger Br. p. 12.) This ignores completely the nature of the changes which were made. As originally worded in the House Bill, Section 115(f)(1) provided that a corporate distribution in stock "shall be treated as a taxable dividend to the extent that such distribution constitutes income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution *and represents a distribution of earnings or profits accumulated after February 28, 1913.*" H.R. 12395, 74th Cong., 2d Sess. The italicized portion was not in accord, however, with Section 115(a) as amended by the Senate Finance Committee, since that amendment defined a dividend to include both distributions out of earnings and profits accumulated after February 28, 1913, and distributions out of earnings and profits of the taxable year. The Senate Finance Committee revised the House version of Section 115(f)(1) in two respects: first, it struck out the italicized words, thereby making Section 115(f)(1) consistent with Section 115(a), and second, it reworded the section in the negative. It is obvious that only the former change was referred to by the Senate Finance Committee when it spoke of "changes made necessary by virtue of the reported amendment of Section 115(a)." The rephrasing in the negative was not required by the amendment of Section 115(a) and must have been, as the Senate Report indicates, "in the interest of greater clarity."

19, 74th Cong., 2d Sess.)

Thus it is clear upon the face of the statute itself that at least *some* types of stock dividends were not to be taxed. The types themselves were not described, but the legislative purpose is given content by reference to the judicial background in the light of which Section 115(f) (1) was passed.

If any doubt of the congressional intent could possibly remain, it is completely dispelled by the declarations of purpose which accompanied the enactment of Section 115 (f). (1). See *Duplex Printing Press Co. v. Deering*, 254 U. S. 443, 475 (1921); *Wright v. Vinton Branch of Mountain Trust Bank*, 300 U. S. 440, 463 (1937). The amendment of Section 115 (f) was initiated in the House of Representatives. Representative Vinson, speaking for the Subcommittee on Taxation of the House Ways and Means Committee, voiced that committee's approval of the proportional interest test as defined in *Eisner v. Macomber* and expressly disclaimed any intention to tax stock dividends which came within the rule of that case. Thus, in 80 Cong. Rec., Part 6, pp. 6214-15, 6309-10, the following explanatory statements appear:

> ". . . In no sense is this an attack upon the Eisner against Macomber decision. There are many dividends received in stock and stock rights that are

distinguishable from the character of stock dividend in the Macomber case, supra, and are actual realized taxable income.

As we see it, a stock dividend that is not taxable is one in which the relative interest of each shareholder of a corporation is unchanged in his stock ownership.

. . . . . .

. . . under the 1934 act there was a provision that said no stock dividend should be taxed. In a very celebrated case, Eisner against Macomber, the Supreme Court held that the tax dividend involved in that case was not taxable. Out of that case grew up the idea that no stock dividend was taxable. I think it was because of that notion that the language to which I have referred, as appears in the 1934 bill, found its way there; that is, that no stock dividend should be taxed.

The proposed plan does not change the law and does not in the slightest degree strike at the decision of the Supreme Court in the case of Eisner and Macomber in respect of a stock dividend where there is no change in the proportion of ownership by the shareholder."

The interpretation given Section 115(f)(1) by the Treasury Department was in accordance with this declaration of congressional intent, and from 1936 until January, 1942, the Department's Regulations expressly exempted stock dividends of the *Macomber*

type from tax.[21] During the intervening years Congress re-enacted Section 115(f)(1) without change,[22] thereby giving its approval to the construction which had been placed upon the section by the Treasury Department in its regulations and in the administration of the Act. It is the settled rule that in the interpretation of a doubtful or ambiguous statute, great weight will be given to the contemporaneous administrative construction by those charged with enforcement of the Act, particularly when Congress, knowing of that construction, thereafter re-enacts the statute without change. *Poe v. Seaborn*, 282 U. S. 101, 116 (1930); *McCaughn v. Hershey Chocolate Co.*, 283 U. S. 488, 492 (1931); *Massachusetts Mutual Life Insurance Co. v. United States*, 288 U. S. 269, 273 (1933).

It is therefore plain that in 1936 when Section 115(f) was amended Congress believed that the decision of this Court in *Eisner v. Macomber* was correct and did not intend to tax stock dividends of the *Macomber* type.

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[21] Treasury Regulations 94, Art. 115-7; Treasury Regulations 101, Art. 115-7; Treasury Regulations 103, Sec. 19.115-7, amended January 19, 1942, by T. D. 5110, 1942-4 Int. Rev. Bull. 7.

[22] Section 115(f)(1), Revenue Act of 1938, c. 289, 52 Stat. 447.

We do not believe that a judicial overruling of the *Macomber* case such as petitioner requests could alter the legislative intent incorporated in Section 115(f) (1) when it was enacted. It is a time-honored rule of statutory construction that a statute speaks as of the date of its enactment and that its language is to be taken in the sense in which it was understood at the time the statute was passed. *Schuyler v. Thomas*, 98 U. S. 169, 172 (1878); *In re Heath*, 144 U. S. 92 (1892); *Platt v. Union Pacific Railroad Company*, 99 U. S. 48 (1878); *Apex Hosiery Co. v. Leader*, 310 U. S. 469 (1940). In the words of Mr. Justice Strong in the *Platt* case, supra, at p. 63:

> "There is always a tendency to construe statutes in the light in which they appear when the construction is given. It is easy to be wise after we see the results of experience . . . But in endeavoring to ascertain what the Congress of 1862 intended, we must, as far as possible, place ourselves in the light that Congress enjoyed, look at things as they appeared to it, and discover its purpose from the language used in connection with the attending circumstances."

It is no answer to this principle to say, as does petitioner, that in using the language employed in Section 115(f) (1) Congress intended to make the taxability of stock dividends coextensive with its taxing

power under the constitution. (Strassburger Br. p. 11.) The taxing power which Congress believed it had in 1936 did not extend beyond the bounds of the *Macomber* case, and Section 115(f) (1) was incorporated in the 1936 Act in express recognition of the constitutional limitations laid down in that case. Even if it should now develop, as urged by petitioner, that the decision in the *Macomber* case was wrong, the fact would remain that Congress in 1936 believed it was correct and enacted Section 115(f) (1) on the assumption and with the assurance that stock dividends of the *Macomber* type would not be taxed."

This Court has held that the legislative intention cannot be enlarged by judicial construction in order to adapt it to a subsequently disclosed constitutional

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"Section 115(f)(1) must be read and construed in the light of every other material part of the tax statute. *White v. United States*, 305 U. S. 281 (1938). Section 112 (b) (2) of the Revenue Act of 1936, c. 690, 49 Stat. 1648, provides in part:

> "No gain or loss shall be recognized if common stock in a corporation is exchanged solely for common stock in the same corporation . . ."

The same provision appears in Section 112(b)(2) of the Revenue Acts of 1928, 1932 and 1934. Likewise in Section 112(b)(1) of the Revenue Acts of 1928, 1932, 1934 and 1936, Congress has declared that an exchange of business property for property of like kind shall be tax-free. All of these provisions disclose a congressional plan to exempt from tax transactions which do not result in any substantial change in the taxpayer's interest. A stock dividend of common stock on common stock is so closely akin to these tax-free transactions that the exemption of such a dividend from tax is consistent with the general congressional intent demonstrated in these sections.

power. The point is well illustrated by several cases involving the taxability of joint tenancies and estates by the entireties under the 1916 estate tax law. (39 Stat. 777.) In *Knox v. McElligott*, 258 U. S. 546 (1922), the Court had refused to construe the 1916 Act as applicable to a joint estate created prior to 1916, since to give the Act retroactive effect would raise grave doubts concerning the constitutional power to tax interests "vested" in another than the decedent before death and before the Act was passed. Thereafter, in *Tyler v. United States*, 281 U. S. 497 (1930), it became established that because there was a "shift of economic benefit" at the decedent's death there was no constitutional objection to taxing such a tenancy, and in *Gwinn v. Commissioner*, 287 U. S. 224 (1932), it was held that when the Act was made expressly retroactive it could be constitutionally applied to a tenancy created before 1916. Nevertheless, in *Cahn v. United States*, mem. 297 U. S. 691 (1936), when the question arose under the 1918 Act, which, like the 1916 Act, was not expressly retroactive, the Court followed its decision in the *Knox* case and refused to construe the statute as applicable to a joint estate created prior to the Act. In other words, the Court held that the language used in the Revenue Act of 1916 still meant what the Court had

construed it to mean in the *Knox* case, despite the fact that the constitutional doubts which led to the decision in the *Knox* case had since been resolved.

There is nothing in this Court's decision in *United States v. Wrightwood Dairy Co.*, 315 U. S. 110 (1942) (cited at p. 13, Strassburger Br.), which lends support to petitioner's argument. On the contrary, the case is direct authority for the rule of statutory construction which we are asking the Court to apply in this case. The *Wrightwood* case dealt with the intended scope of the Agricultural Marketing Agreement Act of 1937, which authorized the Secretary of Agriculture to regulate the handling of products "directly affecting" interstate commerce. It was urged that the use of the word "directly" indicated an intention by Congress to exercise less than all its constitutional power and did not confer authority over the marketing of intrastate products. The Court found, however, that this language had been adopted from the Supreme Court's opinion in *Schechter Poultry Corp. v. United States*, 295 U. S. 495, 544-8 (1935), where the test was said to be that only those intrastate transactions which "directly affect" interstate commerce come within the reach of the commerce power. The Court concluded from this and other evidence that Congress in enacting the Marketing Act

had intended to exercise its power to the full extent permitted by the commerce clause.

Had the Court in the *Wrightwood* case found that the commerce power was broader than the definition in the *Schechter* case, and had it then construed the Act as encompassing this broader power, despite the fact that Congress had adopted the limitations laid down in the *Schechter* case, it would have done what the petitioner asks the Court to do here. Instead, however, the Court read the *Schechter* case and the words of the Marketing Act together, and the extent of the power which Congress sought to exercise was ascertained by reference to the judicial decision on which the statutory language was based. If in the present case a similar analysis is made of Section 115(f) (1), the intended scope of that provision becomes clear. Congress was adopting as its conception of income the one developed by this Court in *Eisner v. Macomber* and *Koshland v. Helvering*, and the fundamental purpose of Section 115(f) (1) was to make the limitations laid down in those cases a part of the 1936 law.

It is evident from the legislative and judicial background of Section 115 (f) (1), from the limitations implicit in its language, from the interpretation given the section by the Treasury Department's Regulations,

and from the declaration of Congressional purpose which accompanied its passage that Congress in enacting that section did not intend to tax stock dividends of the type involved in *Eisner v. Macomber* and in the case at bar. It is likewise clear that the intent thus incorporated in Section 115(f) (1) when it was enacted would not be altered by a judicial overruling of the *Macomber* case. Since the stock dividend in the instant case is nontaxable under the doctrine of *Eisner v. Macomber*, Congress in passing Section 115 (f) (1) did not intend to subject it to tax. The judgment of the lower court in this case[*] may be affirmed on this ground alone, without the necessity of considering petitioner's request that this Court take the grave step of overruling *Eisner v. Macomber*.

---

[*]We express no opinion as to the applicability of this view of Section 115(f)(1) in Strassburger v. Helvering, No. 66.

CONCLUSION

We submit that the judgment of the Circuit Court of Appeals was correct and should be affirmed.

Respectfully submitted,

CHARLES E. MCCULLOCH,
Counsel for Respondent.

HART, SPENCER, MCCULLOCH AND ROCKWOOD,
Of Counsel for Respondent.

Appendix

Constitution of the United States:

Article I, Section 2, Clause 3.—Representatives and direct Taxes shall be apportioned among the several States which may be included within this Union, according to their respective Numbers, which shall be determined by adding to the whole Number of free Persons, including those bound to Service for a Term of Years, and excluding Indians not taxed, three-fifths of all other Persons . . .

Article I, Section 9, Clause 4.—No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken . . .

. . . . . .

Sixteenth Amendment.—The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration . . .

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from . . . dividends, . . .

. . . . . .

(d) *Distributions by Corporations.*—Distributions by corporations shall be taxable to the

shareholders as provided in section 115.

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this title . . . means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

(b) *Source of Distributions.*—For the purposes of this Act every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits . . .

. . . . . .

(f) *Stock Dividends.*—

(1) *General Rule.*—A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution.

. . . . . .

(j) *Valuation of Dividend.*—If the whole or any part of a dividend is paid to a shareholder

in any medium other than money the property received other than money shall be included in gross income at its fair market value at the time as of which it becomes income to the shareholder.

Treasury Regulations 94, relating to the Revenue Act of 1936:

ART. 115-7. Stock dividends.—A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall be treated as a dividend to the full extent that it constitutes income to the shareholders within the meaning of the sixteenth amendment to the Constitution. The Supreme Court has pointed out some of the characteristics distinguishing a stock dividend which constitutes income from one which does not constitute income within the meaning of the Constitution.[1] The distinction between a stock dividend which does not, and one which does, constitute income to the shareholder within the meaning of the sixteenth amendment to the Constitution is the distinction between a stock dividend which works no change in the corporate entity, the same interest in the same

[1] See *Eisner v. Macomber* (252 U. S. 189, T. D. 3010, C. B. 3-25); and *Koshland v. Helvering* (56 Sup. Ct. 767, Ct. D. 1124, C. B. XV-1, 219). Compare *United States v. Phellis* (257 U. S. 156, T. D. 3270, C. B. 5, 37); *Rockefeller v. United States* (257 U. S. 176, T. D. 3271, C. B. 5, 34); *Cullinan v. Walker* (262 U. S. 134, T. D. 3508, C. B. 11-2, 55); *Weiss v. Stearn* (265 U. S. 242, T. D. 3609, C. B. III-2, 51); and *Marr v. United States* (268 U. S. 536, T. D. 3755, C. B. IV-2, 116).

corporation being represented after the distribution by more shares of precisely the same character, and a stock dividend where there either has been a change of corporate identity or a change in the nature of the shares issued as dividends whereby the proportional interest of the shareholder after the distribution is essentially different from his former interest. A stock dividend constitutes income if it gives the shareholder an interest different from that which his former stock holdings represented. A stock dividend does not constitute income if the new shares confer no different rights or interests than did the old—the new certificates plus the old representing the same proportionate interest in the net assets of the corporation as did the old.

Example (1): The X Corporation had an authorized capital stock of $300,000 of common stock, par value $10 a share, and $100,000 of 7 percent cumulative preferred stock, par value $100 a share, which is preferred as to dividends, has no voting rights, and may be redeemed at any time at $105 per share. The articles of incorporation provide that the annual dividend on the preferred stock may be paid in cash or, at the option of the corporation, in one share of common stock for each share of preferred. On July 1, 1936, the X Corporation had outstanding $200,000 of common stock and $100,000 of preferred stock, earnings and profits of $60,000 accumulated since February 28, 1913, and earnings and profits of the taxable year amounting to

$15,000. On July 1, 1936, it distributed 1,000 shares of its common stock of an aggregate par value (and fair market value) of $10,000 to the holders of its preferred stock in payment of the annual dividend on such stock. The stock so distributed constitutes a taxable stock dividend to the holders of the preferred stock.

Example (2): On July 1, 1936, the Y Corporation had an authorized capital stock consisting of 1,000 shares of common stock, par value $100 a share, of which 500 shares were outstanding. It had earnings and profits of $40,000 accumulated since February 28, 1913, and $5,000 of earnings and profits of the taxable year. On July 1, 1936, the Y Corporation issued and divided among its shareholders 250 additional shares of its common stock of a total par value of $25,000 and transferred an equivalent amount from surplus account to capital stock account. The stock so distributed does not constitute a taxable stock dividend to the shareholders.

Example (3): The Z Corporation had an authorized capital stock of 30,000 shares of common, without par value, and 10,000 shares of 7 percent cumulative preferred stock, par $100, which is preferred as to dividends, has voting rights and may be redeemed on the 1st of January or July of any year by the payment of $105 per share and accrued dividends. On July 1, 1936, the company's issued and outstanding stock amounted to 20,000 shares of

common and 6,000 shares of preferred, and it had $250,000 earnings and profits accumulated since February 28, 1913, and $90,000 earnings and profits of the taxable year. On July 1, 1936, it paid a dividend on its common stock in preferred stock at the rate of 1/10 share of preferred on each share of common outstanding. The preferred stock so distributed constitutes a taxable stock dividend to the holders of common stock.

FILE COPY

No. 894 22

In the Supreme Court of the United States

OCTOBER TERM, 1941

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

R. A. SPROUSE

PETITION FOR REHEARING ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

In the Supreme Court of the United States

OCTOBER TERM, 1941

No. 894

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

R. A. SPROUSE

PETITION FOR REHEARING ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

Comes now the Solicitor General, on behalf of the petitioner, and respectfully prays for a reconsideration by the Court of its order of March 2, 1942, denying certiorari herein.

Following the decision in *Eisner* v. *Macomber*, 252 U. S. 189, Congress undertook to modify the revenue acts so as to accord with what it thought to be the constitutional limitations upon the taxing power announced by that decision. However, it appeared some sixteen years later that in the confusion following *Eisner* v. *Macomber*, Congress had placed an unnecessarily sweeping inter

448584—42

pretation upon that decision. See *Koshland* v. *Helvering*, 298 U. S. 441, 444-445. In order to forestall any possible future misunderstanding as to the exercise of the taxing power with respect to stock dividends, Congress in 1936 changed the statutory provisions so as to make taxability coextensive with the taxing power under the Constitution itself. Section 115 (f) of the Revenue Act of 1936.

Accordingly, since 1936, a stock dividend is relieved of tax under the statute, *only if the Constitution* so requires. The Government has long felt that *Eisner* v. *Macomber* was incorrectly decided, and since the question is one of Constitutional law, its only feasible recourse is to ask this Court for a reexamination.

We believe that the Constitution does not prevent the taxation of a distribution of corporate earnings in the form of stock dividends, and the statute relieves the dividend of tax only where required by the Constitution. In the case of one large corporation alone, distributions were made during 1941 to over 600,000 stockholders, the taxability of which is thought to depend upon *Eisner* v. *Macomber*. The instant case was presented to this Court in order promptly to determine the present status of *Eisner* v. *Macomber*.

The refusal of the Court to consider the question will result in unnecessary uncertainty in the audit of thousands of returns. It is respectfully

submitted that it is a matter of substantial public importance that the order denying the petition for certiorari be vacated and that the petition for certiorari be granted.

CHARLES FAHY,
Solicitor General.

I certify that this petition is presented in good faith and not for delay.

CHARLES FAHY,
Solicitor General.

MARCH 1942.

U. S. GOVERNMENT PRINTING OFFICE 1942

SUPREME COURT OF THE UNITED STATES.

Nos. 22 and 66.—October Term, 1942.

Guy T. Helvering, Commissioner of Internal Revenue, Petitioner, vs. R. A. Sprouse.	On Writ of Certiorari to the United States Circuit Court of Appeals for the Ninth Circuit.
22	
Emil H. Strassburger, Petitioner, vs. Commissioner of Internal Revenue.	On Writ of Certiorari to the United States Circuit Court of Appeals for the Second Circuit.
66	

[April 5, 1943.]

Mr. Justice Roberts delivered the opinion of the Court.

Certiorari was granted because the decisions below in the two cases conflict. They arise under § 115(f)(1) of the Revenue Act of 1936:[1]

"A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution."

No. 22.

The respondent owned voting common stock in an Oregon corporation which paid a ten per cent. stock dividend in shares of non-voting common stock. The company had outstanding but two classes of stock, voting common of a par value of $397,471.25 and non-voting common of a par value of $819,333.06. The dividend was of non-voting common of a par of $121,680.43 and was distributed to holders of the voting and non-voting common. The fair market value of the stock distributed as a dividend was its par value and the earnings or profits available for distribution were in excess of its total value. Neither the voting rights of the voting common, nor its right to share in dividends and in liquidation, was altered by the distribution.

[1] c. 690, 49 Stat. 1648, 1688.

The respondent, who owned no non-voting common, received 200 shares of that class of stock. In his return for 1936 he did not report the dividend as income. The Commissioner determined a deficiency by including the value of the dividend as income, and the Board of Tax Appeals sustained him.[2] The Circuit Court of Appeals reversed, holding that the dividend was not constitutionally the subject of income tax if it was distributed to holders of both classes of outstanding stock in proportion to their respective holdings. It accordingly remanded the case to the Board to find the facts and to apply the rule announced.[3]

No. 66.

Petitioner owned 200 shares of common,—the entire stock of a corporation. By charter amendment the creation of an issue of 500 shares of 7% Cumulative Non-Voting Preferred Stock, of $100 par value, was authorized. The directors voted a distribution to stockholders of $5,000 par of the preferred stock and the petitioner, as sole stockholder, received fifty shares as a stock dividend. The earnings available for dividends were in excess of the value of this stock. Petitioner still holds the preferred stock and no dividends have been paid upon it. The petitioner failed to return the stock dividend as income, the respondent determined a deficiency, and the Board of Tax Appeals affirmed his action. The Circuit Court of Appeals affirmed the Board's decision.[4]

We think the judgment in No. 22 was right and that in No. 66 erroneous. The cases are ruled by *Helvering* v. *Griffiths*, No. 467, Oct. Term 1942. While the petitioner in No. 66 received a dividend in preferred stock, the distribution brought about no change whatever in his interest in the corporation. Both before and after the event he owned exactly the same interest in the net value of the corporation as before. At both times he owned it all and retained all the incidents of ownership he had enjoyed before.

In No. 22 the respondent insists that the distribution of the dividend in nowise disturbed the relationship previously existing amongst all the stockholders or that previously existing between the respondent and the corporation. The court below has held that, if this is true, the dividend did not constitute income.

---

[2] 42 B. T. A. 484.
[3] 122 F. 2d 973.
[4] 124 F. 2d 315.

We think *Koshland* v. *Helvering*, 298 U. S. 441, distinguishable. That was a case where there were both preferred and common stockholders and where a dividend in common was paid on the preferred. We held, in the circumstances there disclosed, that the dividend was income but we did not hold that any change whatsoever in the character of the shares issued as dividends resulted in the receipt of income. On the contrary the decision was that, to render the dividend taxable as income, there must be a change brought about by the issue of shares as a dividend whereby the proportional interest of the stockholder after the distribution was essentially different from his former interest.

No. 22. Judgment affirmed.

No. 66. Judgment reversed.

Mr. Justice RUTLEDGE took no part in the consideration or decision of these cases.

Mr. Justice REED, Mr. Justice FRANKFURTER, and Mr. Justice JACKSON dissent from each judgment. They are of opinion that *Koshland* v. *Helvering*, 298 U. S. 441, requires contrary conclusions.

A true copy.

Test:

Clerk, Supreme Court, U. S.

CLERK'S COPY.

TRANSCRIPT OF RECORD

Supreme Court of the United States

OCTOBER TERM, 1942

No. 66

EMIL H. STRASSBURGER, PETITIONER,

vs.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITION FOR CERTIORARI FILED APRIL 3, 1942.

CERTIORARI GRANTED MAY 11, 1942.

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1942

No. 66

EMIL H. STRASSBURGER, PETITIONER,

vs.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

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JUDD & DETWEILER (INC.), PRINTERS, WASHINGTON, D. C., JULY 22, 1942.

United States Circuit Court of Appeals

1

FOR THE SECOND CIRCUIT.

EMIL H. STRASSBURGER,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Docket No. 100,303.

APPEARANCES: 2

For Taxpayer: LEO BRADY, ESQ.

For Commissioner: WALT MANDRY, ESQ.

Docket Entries.

1939

Oct. 11—Petition received and filed. Taxpayer notified. (Fee paid).

Oct. 11—Copy of petition served on General Counsel.

Nov. 24—Answer filed by General Counsel.

Nov. 24—Request for hearing in New York City filed by General Counsel. 3

Nov. 27—Notice issued placing proceeding on New York City Calendar. Answer and request served.

1940

Aug. 20—Hearing set October 21, 1940, New York City.

Oct. 24—Hearing had before Mr. Van Fossan on the merits. Submitted. Petitioner granted leave to file amendment to petition. Stipulation of facts filed. Appearance of Leo Brady filed. Amendment to petition filed. Answer to amendment to petition filed. Briefs due as per Rules.

Nov. 12—Transcript of hearing October 24, 1940, filed.

Dec. 6—Motion for extension to December 21, 1940, to file brief filed by General Counsel. December 9, 1940, granted.
Dec. 7—Brief filed by taxpayer.
Dec. 21—Brief filed by General Counsel.
Dec. 23—Copy of brief served on General Counsel.

1941

Feb. 10—Memorandum findings of fact and opinion rendered, Van Fossan, Division 9. Decision will be entered for the respondent.

5

Feb. 10—Decision entered, Van Fossan, Division 9.
May 5—Petition for review by United States Circuit Court of Appeals, Second Circuit, with assignments of error filed by taxpayer.
May 5—Proof of service filed by taxpayer.
June 27—Agreed praecipe for record filed—with proof of service thereon.

Petition.

(Filed October 11, 1939.)

6 UNITED STATES BOARD OF TAX APPEALS.

[SAME TITLE]

Docket No. 100,303.

The above named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency, bearing no symbols, dated July 18, 1939, and as a basis of his proceeding alleges as follows:

(1) The petitioner is Emil H. Strassburger residing at 480 Park Avenue, New York, N. Y. The return for the period here involved was filed with the Collector for the Second District of New York.

(2) The notice of deficiency, a copy of which is hereto attached and marked "Exhibit A" was mailed to the petitioner on or about the date of the notice, July 18, 1939.

(3) The taxes in controversy are income taxes for the calendar year 1936, in the amount of $949.39. The determination of tax set forth in the said notice of deficiency is based upon the following error:

(a) Inclusion in taxpayer's income of dividends in the amount of $5,000.

(4) The facts upon which the petitioner relies as a basis of this proceeding are as follows:

(a) The dividend in the amount of $5,000. was a stock dividend.

(b) Taxpayer owned all of the outstanding stock of the corporation which declared said dividend, namely, E. H. Strassburger, Inc.

(c) The stock dividend was in preferred stock—50 shares 7% cumulative with no voting rights.

(d) There was no change of the character of the taxpayer's interest in the said corporation.

(e) The dividend was not an artifice or device to evade the tax laws.

WHEREFORE, petitioner prays that this Board may hear the proceeding and determine no deficiency or liability.

EMIL H. STRASGBURGER.

10 *Petition.*

State of New York, }
County of New York, } ss.:

EMIL H. STRASSBURGER, being duly sworn, deposes and says: That he is the petitioner in the foregoing petition; that he has read the foregoing petition and knows the contents thereof; that the same is true to his own knowledge, except as to the matters therein stated to be alleged on information and belief, and that as to those matters he believes it to be true.

11 EMIL H. STRASSBURGER.

Sworn to before me this
7th day of October, 1939.

A. K. PONS,
Notary Public, Queens Co. No. 1579,
Queens County Register's No. 2183,
New York County Register's No. O-P-180,
Certificate filed in N. Y. Co. No. 288,
Commission expires March 30, 1940.

(Seal)

12

13

EXHIBIT A.

TREASURY DEPARTMENT
Internal Revenue Service

Office of
Internal Revenue Agent in Charge
Second New York Division

July 18, 1939

Mr. Emil H. Strassburger
480 Park Avenue
New York, New York

14

Sir:

You are advised that the determination of your income tax liability for the taxable year ended Dec. 31, 1936, discloses a deficiency of $949.39 as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency mentioned.

15

Within 90 days (not counting Sunday or a legal holiday in the District of Columbia as the 90th day) from the date of the mailing of this letter, you may file a petition with the United States Board of Tax Appeals for a redetermination of the deficiency.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to Revenue Agent in Charge, 90 Church Street, New York, N. Y., for the attention of LAL-90 D. The signing and filing of this form will expedite the closing of your return(s) by permitting an early assessment of the deficiency, and will prevent the accumulation of interest,

since the interest period terminates 30 days after filing the form, or on the date assessment is made, whichever is earlier.

Respectfully,

GUY T. HELVERING
Commissioner

By C. R. KRIGBAUM
Internal Revenue Agent in Charge

Enclosures
Statement.
Form of waiver.

EXHIBIT A.

STATEMENT

Mr. Emil H. Strassburger
480 Park Avenue
New York, New York.

Tax Liability for the Taxable Year Ended December 31, 1936

	Liability	Assessed	Deficiency
Income tax	$2,695.80	$1,746.41	$949.39

In making this determination of your income tax liability, careful consideration has been given to the report of examination dated January 25, 1938; to your protest dated April 11, 1938; and to the statements made at the conferences held on November 18, 1938, and January 23, 1939.

A copy of this letter and statement has been mailed to your representative, Mr. Leo Brady, 535 Fifth Avenue, New York, New York, in accordance with the authority contained in the power of attorney executed by you and on file with the Bureau.

Adjustment to Net Income

Net income as disclosed by return	$20,984.75
Unallowable deductions and additional income:	20
(a) Dividends	5,000.00
Net income adjusted	$25,984.75

Explanation of Adjustment

(a) The preferred stock of a par value of $5,000.00 issued to you by E. H. Strassburger, Inc., constituted income under the Sixteenth Amendment to the Constitution and, therefore, was not exempt from tax under the provisions of section 115 (f) of the Revenue Act of 1936 (see case of Frank J. and Hubert Kelly Trust, 38 B. T. A. #128). 21

Computation of Tax

Revenue Act of 1936

Net income adjusted	$25,984.75
Less: Personal exemption	2,500.00
Balance (surtax net income)	$23,484.75
Less: Earned income credit	1,400.00
Net income subject to normal tax	$22,084.75

22 *Answer.*

Normal tax at 4% on $22,084.75	$ 883.39
Surtax on $23,484.75	1,812.41
Total tax	$ 2,695.80
Correct income tax liability	$ 2,695.80
Income tax assessed:	
Original Account No. 212884	1,746.41
23 Deficiency of income tax	$ 949.39

Answer.

(Filed November 24, 1939.)

UNITED STATES BOARD OF TAX APPEALS.

[SAME TITLE]

24 Docket No. 100,303.

Comes now the Commissioner of Internal Revenue, by his attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, and in answer to the petition filed herein, admits and denies as follows:

1. Admits the allegations contained in paragraph 1 of the petition.

2. Admits the allegations contained in paragraph 2 of the petition.

3. Admits that the taxes in controversy are income taxes for the calendar year 1936 in the amount of $949.39

as alleged in paragraph 3 of the petition but denies that the respondent committed error as alleged in said paragraph.

4(a). Admits the allegations contained in subparagraph (a) of paragraph 4 of the petition.

(b). Denies the allegations contained in subparagraph (b) of paragraph 4 of the petition.

(c). Admits the allegations contained in subparagraph (c) of paragraph 4 of the petition.

(d) and (e). Denies the allegations contained in subparagraphs (d) and (e) of paragraph 4 of the petition.

Denies generally and specifically each and every allegation contained in the petition not hereinabove admitted or denied.

WHEREFORE, it is prayed that the determination of the Commissioner be approved and the appeal denied.

(Signed) J. P. WENCHEL,
ECA
Chief Counsel,
Bureau of Internal Revenue.

Of Counsel:

E. O. HANSON,
Division Counsel,
WALT MANDRY,
Special Attorney,
Bureau of Internal Revenue.

KB
11/17/39

28

Amended Petition.

(Filed October 24, 1940.)

UNITED STATES BOARD OF TAX APPEALS.

[SAME TITLE]

Docket No. 100,303.

29 The petition in the above matter, sworn to October 7, 1939, shall be and hereby is amende to include at the end of the present paragraph (4) (e) the following:

"(5) (a) The inclusion of the stock dividend in question in taxpayer's gross income and the determination of tax liability resulting therefrom is without warrant either under the United States Constitution, the Federal Statutes and Regulations with respect to the taxation of income thereunder."

"(5) (b) The Statutes and Regulations insofar as the same may purport to tax the stock dividend made 30 to the petitioner herein are illegal, unconstitutional and void for want of certainty, clarity and definiteness and impose no tax basis or formula for the computation of tax liability."

Dated, New York, October 23, 1940.

LEO BRADY,
Attorney for Petitioner.

31

Answer to Amended Petition.

(Filed October 24, 1940.)

UNITED STATES BOARD OF TAX APPEALS.

[SAME TITLE]

Docket No. 100,303.

COMES Now the Commissioner of Internal Revenue by his attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, and for answer to the amendment to the petition filed in these proceedings admits and denies as follows: 32

5(a) and (b). Denies the allegations contained in subparagraphs (a) and (b) of paragraph 5 of the amendment to the petition.

WHEREFORE, respondent prays that the amended petition be denied and that the respondent's determination be in all respects approved.

33

(Signed) J. P. WENCHEL,
ECA
Chief Counsel,
Bureau of Internal Revenue.

Of Counsel:

E. O. HANSON,
Division Counsel.

WALT MANDRY,
Special Attorney,
Bureau of Internal Revenue.

em 10-23-40

34

Memorandum Findings of Fact and Opinion.

UNITED STATES BOARD OF TAX APPEALS.

[SAME TITLE]

Docket No. 100,303.

Petitioner, the owner of all the issued voting common stock of a corporation, which was the only stock
35 outstanding, received a dividend of 50 shares of nonvoting cumulative preferred stock. *Held*, that the preferred stock constituted a taxable dividend within the meaning of the Sixteenth Amendment to the Constitution. *John M. Keister*, 42 B. T. A. 484, followed.

LEO BRADY, ESQ., for the Petitioner.

WALT MANDRY, ESQ., for the Respondent.

Respondent determined a deficiency in petitioner's income tax for the year 1936 in the sum of $949.39. The
36 single issue before the Board is whether or not the receipt of a dividend of preferred stock by petitioner, sole owner of the issuing corporation's common stock, the only stock of the corporation outstanding, was income taxable to petitioner.

FINDINGS OF FACT.

The facts were stipulated substantially as follows:

Petitioner resides in New York, New York.

E. H. Strassburger, Inc., sometimes hereinafter referred to as the Corporation, is a New York corporation

organized in or about January, 1932, with its principal place of business at 740 Broadway, New York, New York.

On December 10, 1936, the authorized capital stock of the Corporation consisted of 200 shares of common stock with exclusive voting rights. All of this stock was owned by petitioner.

On December 11, 1936, the Corporation's articles of incorporation were duly amended for the creation and authorization of an issue of 500 shares of $100 par value, 7 per cent, cumulative, non-voting preferred stock.

On December 21, 1936, the board of directors of the 38
Corporation held a meeting at which a resolution was adopted of which the following is material:

> "Now, Therefore, Be It Resolved, that for the purpose of representing in the capitalization of this corporation surplus assets to the extent of Five Thousand Dollars, a distribution among stockholders of the capital stock of the corporation be made of Five Thousand Dollars of preferred capital stock, and the proper officers of the corporation are hereby authorized and directed to issue an aggregate of Five Thousand Dollars, par value of preferred capital stock 39
> of this corporation, in payment of a stock dividend on the common stock of this corporation.
>
> "Further Resolved, that the directors of this corporation be authorized to distribute said Five Thousand Dollars of the preferred capital stock, pro rata, among stockholders, as and for a stock dividend on said capital stock so owned by them, such distribution to be made to stockholders of record at the close of business on December 24, 1936."

On December 24, 1936, pursuant to the resolution adopted on December 21, 1936, 50 shares of preferred

40 *Memorandum Findings of Fact and Opinion.*

stock of the Corporation were issued to petitioner, the sole common stockholder. At the time of the distribution of the stock dividend the Corporation had earnings and profits accumulated subsequent to February 28, 1913, in excess of $5,000. Appropriate book entries were made on account of the dividend, decreasing the surplus of the Corporation by $5,000 and increasing its capital stock in the same amount.

On December 29, 1936, the 50 shares of preferred stock which petitioner had received as a dividend were trans-
41 ferred to his wife, Gertrude W. Strassburger. Upon her death the shares were retransferred to petitioner who is now the record holder. No dividends have been paid on the preferred stock and that stock has never been disposed of, canceled or retired.

OPINION.

VAN FOSSAN: The only issue for our determination is whether or not petitioner, holder of all the issued common stock of E. H. Strassburger, Inc., which was the
42 only stock of that corporation outstanding, received taxable income within the meaning of the Sixteenth Amendment to the Constitution upon receipt of a dividend of preferred stock. Petitioner contends that the dividend was not a taxable one because his proportionate interest in the Corporation did not change upon its receipt. He urges that even if the dividend were constitutionally taxable Congress did not intend to tax a dividend such as we have before us. Respondent argues that the dividend of the preferred shares changed the character of petitioner's interest in the Corporation and hence constitutes a taxable distribution.

The provisions of the statute here applicable are section 115 (a) and section 115 (f) of the Revenue Act of 1936[1].

We are of the opinion that the instant case is controlled by *John M. Keister*, 42 B. T. A. 484. In that proceeding we held that a dividend of non-voting common stock received by holders of voting common stock was a taxable dividend and said:

> • • • the nonvoting common stock was not "of precisely the same character" as the stock previously 44
> held by them. By the receipt of the dividend each holder of voting common stock received an "interest different from that which its former stockholdings represented." In making this observation we do not

[1] SEC. 115. DISTRIBUTION BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this title (except in section 203 [a] [3] and section 207 [c] [1], relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made dur- 45
ing the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

• • • • • •

(f) *Stock Dividends.*—

(1) *General Rule.*—A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution.

(2) *Election of Shareholders as to Medium of Payment.*—Whenever a distribution by a corporation is, at the election of any of the shareholders (whether exercised before or after the declaration thereof), payable either (A) in its stock or in rights to acquire its stock, of a class which if distributed without election would be exempt from tax under paragraph (1), or (B) in money or any other property (including its stock or in rights to acquire its stock, of a class which if distributed without election would not be exempt from tax under paragraph (1), then the distribution shall constitute a taxable dividend in the hands of all shareholders, regardless of the medium in which paid.

overlook the fact that the value of the additional non-voting common shares received was presumably no greater than a like number of voting common shares which would not be subject to income tax under the opinion in *Eisner* v. *Macomber, supra.* Probably the shares had a less value. But the interest was different, and we think that is all that is required to make the dividend taxable to the holders of voting common stock.

47 In *John M. Keister, supra,* we also considered the taxability of a dividend of non-voting preferred stock to holders of voting and non-voting common shares and stated:

> • • • These features [of the non-voting preferred] gave it an entirely different character from the voting and nonvoting common shares. It clearly represented a different interest in the corporation. It is true, as petitioners point out, that the preferred shares were not to be favored in case of liquidation or dissolution and it is to be noted further that their
48 issuance did not in any way affect the voting control of the corporation, but nevertheless, under the authoritative cases, they represented a new and different interest in the corporation and therefore constituted taxable income. *Koshland* v. *Helvering, supra; Frank J. and Hubert Kelly Trust, supra; Albert E. Smith,* 39 B. T. A. 80.

The preferred stock issued by E. H. Strassburger, Inc. gave petitioner rights different from those he possessed before. The stock carried with it the right to the payment of a fixed amount annually before any dividends upon the common stock could be paid. The fact that the

preferred stock was non-voting would allow petitioner to transfer that stock without changing his voting control. This certainly was an interest differing from his interest as a common shareholder. The dividend stock was also cumulative thus affecting in a material way petitioner's common stockholder interest. We hold that petitioner received a taxable stock dividend in the amount of the fair market value of the preferred stock.

Decision will be entered for the respondent.

Entered Feb. 10, 1941. 50

Decision.

UNITED STATES BOARD OF TAX APPEALS,

WASHINGTON.

[SAME TITLE]

51

Docket No. 100,303.

Pursuant to the determination of the Board, as set forth in its Memorandum Findings of Fact and Opinion, entered February 10, 1941, it is

ORDERED and DECIDED: That there is a deficiency in income tax of $949.39 for the year 1936.

Enter:

(Signed) ERNEST H. VAN FOSSAN,
Member.

Entered Feb. 10, 1941.

52 **Petition for Review.**

(Filed May 5, 1941.)

UNITED STATES BOARD OF TAX APPEALS.

[SAME TITLE]

B. T. A. Docket No. 100,303.

To the Honorable, the Judges of the United States Circuit Court of Appeals for the Second Circuit:

53

I.

Jurisdiction.

Emil H. Strassburger, your petitioner, respectfully petitions this Honorable Court to review the decision of the United States Board of Tax Appeals, entered on February 10, 1941, and finding a deficiency in income tax due from your petitioner for the calendar year 1936 in the amount of $949.39.

The return of income tax, in respect of which the
54 aforementioned tax liability arose, was filed by your petitioner with the Collector of Internal Revenue for the Second Collection District of New York, which is located within the jurisdiction of the Circuit Court of Appeals for the Second Judicial Circuit. Your petitioner at the time of said return resided and still resides at 480 Park Avenue, New York City.

Jurisdiction of this Court to review the decision of the United States Board of Tax Appeals is founded on Sections 1001-3 of the Revenue Act of 1926, as amended by Sections 603 of the Revenue Act of 1928, 1101 of the Revenue Act of 1932 and 519 of the Revenue Act of 1934.

II.

Nature of Controversy.

The parties hereto stipulated upon an agreed statement of facts substantially as follows:

The petitioner, Emil H. Strassburger, a resident of New York, was the sole owner of 200 shares of common stock of E. H. Strassburger, Inc., hereinafter referred to as the corporation. Said corporation was organized in or about January, 1932, under the laws of the State of New York and maintains its principal place of business at 740 Broadway, New York, New York. The shares of stock heretofore mentioned constitute the total authorized capital stock of the corporation and have exclusive voting rights. On December 11, 1936, the corporation's articles of incorporation were duly amended so as to create an issue of 500 shares of $100. par value 7% cumulative non-voting preferred stock. The Board of Directors of the corporation, at a meeting held on December 21, 1936, adopted a resolution, the material portion of which is as follows:

> "Now, Therefore, Be It Resolved, that for the purpose of representing in the capitalization of this corporation surplus assets to the extent of Five Thousand Dollars, a distribution among stockholders of the capital stock of the corporation be made of Five Thousand Dollars of preferred capital stock, and the proper officers of the corporation are hereby authorized and directed to issue an aggregate of Five Thousand Dollars, par value of preferred capital stock of this corporation, in payment of a stock dividend on the common stock of this corporation.

"FURTHER RESOLVED, that the directors of this corporation be authorized to distribute said Five Thousand Dollars of the preferred capital stock, pro rata, among stockholders, as and for a stock dividend on said capital stock so owned by them, such distribution to be made to stockholders of record at the close of business on December 24, 1936."

On December 24, 1936, pursuant to the aforesaid resolution, fifty shares of preferred stock of the corporation
59 were issued to the petitioner, Emil H. Strassburger, sole common stockholder. The corporation at the time of distribution of the stock dividend had earnings and profits accumulated subsequent to February 28, 1913, in excess of $5,000. Appropriate book entries were made on account of the dividend decreasing the surplus of the corporation by $5,000. and increasing its capital stock in like amount.

On December 29, 1936, the petitioner transferred to his wife, Gertrude W. Strassburger, the fifty shares of preferred stock which he had received as a dividend. Said shares were retransferred to petitioner upon the death of
60 his wife, and petitioner is now the record holder. The stock has never been disposed of, cancelled or retired and no dividends have been paid thereon.

The petitioner in his personal income tax return for the calendar year 1936 did not include the stock dividends in the amount of $5,000. He was notified of a deficiency in his tax for the said year and thereafter petition to the United States Board of Tax Appeals was duly filed.

The United States Board of Tax Appeals held that the petitioner received a taxable stock dividend in the amount of the fair market value of the preferred stock. The Board found that the preferred stock issued by E. H.

Strassburger, Inc. gave petitioner rights different from those he possessed before for the reasons:

(a) That the stock carried with it the right to the payment of a fixed amount annually before any dividends upon the common stock could be paid.

(b) That since the preferred stock was non-voting, petitioner could transfer that stock without changing his voting control.

III.

Assignment of Errors.

In making its decision as aforesaid, the United States Board of Tax Appeals committed the following errors upon which your petitioner relies as the basis of this proceeding:

1. The Board erred in holding that the preferred stock issued to petitioner gave him any rights different from those he possessed before.

2. The Board erred in holding that the dividend stock affected in a material way petitioner's common stockholder interests.

3. The Board erred in holding that petitioner received a taxable stock dividend in the amount of the fair market value of the preferred stock.

4. The Board erred in determining that there is a deficiency in income tax due from petitioners in the amount of $949.39 set forth in the final order of determination.

5. The Board erred in failing to determine that there was no deficiency in income tax due from petitioner.

6. The Board erred in failing to determine that the mere receipt of the stock dividend in question does not constitute taxable income to the petitioner under the Constitution, statutes and regulations, and any attempt to impose a tax thereon is without warrant.

7. The Board erred in failing to determine that the
65 statutes and regulations insofar as the same may purport to tax the stock dividend in question are illegal, unconstitutional and void, for want of certainty, clarity and definiteness and impose no tax basis or formula for the computation of tax liability.

WHEREFORE, your petitioner prays that this Honorable Court may review the decision and order of the United States Board of Tax Appeals and reverse and set aside the same and direct said Board to grant the relief sought by petitioner in his petition filed with said Board and to enter an order determining that there is no deficiency in
66 income tax for the calendar year 1936, due from petitioner, and for the entry of such further orders and directions as shall by this Court be deemed meet and proper in accordance with law.

(Signed) LEO BRADY,
Attorney for Petitioner.

State of New York, }
County of New York, } ss.:

LEO BRADY, being duly sworn, deposes and says:

I am the attorney for the petitioner in this proceeding. The foregoing petition was prepared under my supervision and I am familiar with the contents thereof. The allegations of fact contained therein are true to the best of my knowledge, information and belief. The petition is not filed for the purpose of delay, and I believe the petitioner is justly entitled to the relief sought. 68

LEO BRADY.

Sworn to before me this
2nd day of May, 1941.

AUGUSTA E. SCHULZ,
Notary Public, Kings County,
Kings Co. Clk's No. 122, Reg. No. 2141,
N. Y. Co. Clk's No. 320, Reg. No. 2S220,
Bronx Co. Clk's No. 14, Reg. No. 31S42,
Commission expires March 30, 1942. 69

70

Proof of Service.

(Filed May 5, 1941.)

UNITED STATES BOARD OF TAX APPEALS.

[SAME TITLE]

B. T. A. Docket No. 100,303.

To:

71

COMMISSIONER OF INTERNAL REVENUE,
Internal Revenue Building,
Washington, D. C.

J. P. WENCHEL, Esq., Attorney for Respondent,
Chief Counsel,
Bureau of Internal Revenue,
Internal Revenue Building,
Washington, D. C.

YOU ARE HEREBY NOTIFIED that on the 5th day of May,
72 1941, a petition for review by the United States Circuit Court of Appeals for the Second Circuit of the decision of the United States Board of Tax Appeals heretofore rendered in the above entitled cause, was filed with the Clerk of the Board. A copy of the petition as filed is attached hereto and served upon you.

Dated, May 5th, 1941.

LEO BRADY,
Attorney for Petitioner,
165 Broadway,
City of New York.

Service of the foregoing notice of filing and a copy of the petition for review is hereby acknowledged this 5th day of May, 1941.

(Signed) J. P. WENCHEL,
Attorney for Respondent.

Agreed Statement of Facts.

(Filed October 24, 1940.)

UNITED STATES BOARD OF TAX APPEALS.

[SAME TITLE]

Docket No. 100,303.

IT IS HEREBY STIPULATED AND AGREED by and between the parties hereto that the following agreed statement of facts is true and that the case shall be submitted to the United States Board of Tax Appeals upon such agreed statement without testimony:

1. The Petitioner is EMIL H. STRASSBURGER, residing at 480 Park Avenue, New York, New York.

2. The return for the period here involved was filed with the Collector for the Second District of New York.

3. Taxpayer was notified of a deficiency in his personal income taxes for the calendar year 1936 in the amount of

76 *Agreed Statement of Facts.*

$949.39. Thereafter petition to the United States Board of Tax Appeals was duly filed.

4. The deficiency arises by virtue of the inclusion by the Respondent of dividends in the amount of $5,000.

5. The E. H. Strassburger, Inc., is a New York corporation organized in or about January, 1932, with its principal place of business at 740 Broadway, New York, New York.

6. On December 10, 1936, its authorized capital stock
77 consisted of two hundred (200) shares of common stock, with exclusive voting rights, all of which stock was owned by the petitioner.

7. On December 11, 1936, its articles of incorporation were duly amended so as to create and authorize the issuance of five hundred (500) shares of $100. par value, 7 per cent, cumulative, non-voting preferred stock.*

8. On December 21, 1936, at a meeting of its board of directors a resolution was adopted which, in part, reads as follows:

78 "Now, Therefore, Be It Resolved, that for the purpose of representing in the capitalization of this corporation surplus assets to the extent of Five Thousand Dollars, a distribution among stockholders of the capital stock of the corporation be made of Five Thousand Dollars of preferred capital stock, and the proper officers of the corporation are hereby authorized and directed to issue an aggregate of Five Thousand Dollars, par value of preferred capital stock of this corporation, in payment of a stock dividend on the common stock of this corporation.

* A specimen copy of certificate is hereto annexed, made part hereof and marked Exhibit "A".

"FURTHER RESOLVED, that the directors of this corporation be authorized to distribute said Five Thousand Dollars of the preferred capital stock, pro rata, among stockholders, as and for a stock dividend on said capital stock so owned by them, such distribution to be made to stockholders of record at the close of business on December 24, 1936."

9. On December 24, 1936, pursuant to the above resolution, 50 shares of the preferred stock were issued to the sole common stockholder, the petitioner, EMIL H. 80
STRASSBURGER.

10. At the time of the distribution of the stock dividend E. H. Strassburger, Inc. had earnings and profits accumulated subsequent to February 28, 1913, in excess of $5,000. and appropriate book entries were made on account of the dividend decreasing the surplus of the company by $5,000. and increasing its capital stock in the same amount.

11. On December 29, 1936, the said 50 shares of preferred stock were transferred to Gertrude W. Strass- 81
burger, wife of the petitioner. Upon her death the shares were re-transferred to petitioner, EMIL H. STRASSBURGER, who is now the record holder. No dividends have been paid on said preferred stock and said stock has never been cancelled, retired, or otherwise disposed of.

Dated, New York, October 23, 1940.

LEO BRADY,
Counsel for Petitioner.

J. P. WENCHEL,
Chief Counsel,
Bureau of Internal Revenue.

Exhibit "A."

INCORPORATED UNDER THE LAWS OF THE STATE OF NEW YORK

NUMBER P

SHARES

SPECIMEN COPY

E. H. Strassburger Inc.

PREFERRED STOCK

THIS CERTIFIES THAT _____ is the owner of

fully paid and non assessable shares of the PREFERRED CAPITAL STOCK of E. H. STRASSBURGER INC. transferable only on the books of the corporation in person or by attorney upon surrender of this certificate properly endorsed.

The designations, preferences, privileges and voting powers of the shares of each class, and the restrictions or qualifications thereof, shall be as follows:

(a) The holders of the preferred stock shall be entitled to cumulative dividends thereon, at the rate of Seven ($7.00) Dollars per share per annum, and no more, payable out of any and all surplus or net profits of the corporation, as and when declared by the Board of Directors before any dividend shall be declared, set apart for, or paid upon the common shares of the corporation. Said dividends on the preferred stock shall be cumulative, so that if the corporation shall fail in any fiscal year to pay such dividends on all of the issued and outstanding preferred stock, such deficiency in the dividends shall be fully paid before any dividends shall be paid or set apart upon the common share. Subject to the foregoing provisions said preferred stock shall not be entitled to participate in any other or additional surplus or net profits of the corporation.

(b) In the event of the dissolution or liquidation of the corporation, or sale of all its assets, whether voluntary or involuntary, or in the event of its insolvency, or upon any distribution of its capital, there shall be paid to the holders of the preferred stock, the par value thereof, to wit: One Hundred ($100.00) Dollars per share, and the amount of all unpaid accrued dividends thereon, before any sum shall be paid or any assets distributed among the holders of the common shares, and after the payment to the holders of the preferred shares of its par value and the unpaid accrued dividends thereon, the remaining assets and funds of the corporation shall be divided among and paid to the holders of the common shares in proportion of their respective holdings of such shares.

(c) The preferred stock shall have no pre emptive right to or right to subscribe for any additional stock of whatever class, which may at any time be issued by the corporation.

(d) The corporation shall have the option of retiring or redeeming the preferred stock in whole or in part, at any time, from time to time, by paying to such holders thereof, the sum of One hundred and five ($105.00) Dollars for each share of preferred stock, together with any accumulated dividends thereon. Such retirement shall be effected by payment of the surplus fund, if any, of the corporation, but no preferred stock shall be redeemed for cash, under the circumstances, which would produce any impairment of the capital stock of the Company. That such retirement or redemption of the stock can only be effected on one (1) month's notice, which said notice shall be mailed to the stockholders whose stock is to be redeemed or retired, at the address of the stockholder as the same appears upon the stock books of the corporation.

(e) The entire voting power for the election of directors shall be vested in the holders of the common shares, and the holders of the preferred shares shall not be entitled to vote at the election of directors of said corporation or at any other meeting of stockholders for any purpose or on any subject, or to receive notice of any meeting of stockholders except as otherwise expressly provided by law.

IN WITNESS WHEREOF, the duly authorized officers of this corporation have hereunto subscribed their names and caused the corporate seal to be hereto affixed, this _____ day of _____ A D 19

CERTIFICATE

FOR

SHARES

OF THE

ISSUED TO

DATED

85

Praecipe With Proof of Service.

(Filed June 27, 1941.)

UNITED STATES BOARD OF TAX APPEALS.

B. T. A. Docket No. 100,303.

[SAME TITLE]

86

To the Clerk of the United States Board of Tax Appeals:

You will please prepare, transmit, and deliver, to the Clerk of the United States Circuit Court of Appeals, for the Second Circuit, copies duly certified as correct of the following documents and records in the above entitled cause in connection with the Petition for Review by the said Circuit Court of Appeals for the Second Circuit, heretofore filed by the above named Petitioner:

1. Docket entries of the proceedings before the Board.
2a. Petition filed on October 11, 1939.
2b. Answer to petition filed on November 24, 1939.
2c. Amendment to petition, filed on October 24, 1940.
2d. Answer to amendment to petition, filed on October 24, 1940.
3a. Findings of Fact and Opinion of the Board, promulgated on February 10, 1941.
3b. Decision of the Board entered on February 10, 1941.
4a. Petition for Review filed on May 5, 1941.
4b. Notice of filing Petition for Review, filed on May 5, 1941.

87

88 *Praecipe With Proof of Service.*

5a. Agreed Statement of Facts in lieu of Statement of Evidence.

5b. This Praecipe for Record.

5c. Notice of filing this Praecipe for Record and the admission of service thereof.

Said transcript to be prepared as required by law and the rules of the United States Circuit Court of Appeals for the Second Circuit.

89

LEO BRADY,
Attorney for Petitioner.

Service of a copy of this praecipe is hereby admitted this 27th day of June, 1941.

Agreed to.

(Signed) J. P. WENCHEL,
Chief Counsel,
Bureau of Internal Revenue.

90

RAW/JPW 6-27-41
JMM 6-27-41.

91

Clerk's Certificate.

UNITED STATES BOARD OF TAX APPEALS,

WASHINGTON.

Docket No. 100,303.

EMIL H. STRASSBURGER,

Petitioner,

VS.

92

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

I, B. D. GAMBLE, Clerk of the U. S. Board of Tax Appeals, do hereby certify that the foregoing pages, 1 to 29, inclusive, contain and are a true copy of the transcript of record, papers, and proceedings on file and of record in my office as called for by the Praecipe in the appeal (or appeals) as above numbered and entitled.

93

In testimony whereof, I hereunto set my hand and affix the seal of the United States Board of Tax Appeals, at Washington, in the District of Columbia, this 30th day of June, 1941.

B. D. GAMBLE,
Clerk, United States Board of Tax Appeals.

(Seal)

[fol. 32] UNITED STATES CIRCUIT COURT OF APPEALS, FOR THE SECOND CIRCUIT

No. 48—October Term, 1941

(Argued November 13, 1941. Decided December 22, 1941)

EMIL H. STRASSBURGER, Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent

Petition to review a decision of the United States Board of Tax Appeals

The taxpayer seeks reversal of an order of the Board determining a deficiency in income tax for the year 1936. Affirmed.

Before: Swan, Augustus N. Hand and Chase, *Circuit Judges*

Leo Brady, Attorney for Petitioner.

Samuel O. Clark, Jr., Assistant Attorney General; J. Louis Monarch and Morton K. Rothschild, Special Assistants to the Attorney General, for respondent.

[fol. 33] SWAN, *Circuit Judge:*

This appeal presents a case where the owner of all the common stock of a corporation, which had only common stock outstanding, received a stock dividend of 50 shares (par $100 per share) of non-voting, cumulative 7% preferred stock declared out of surplus accumulated subsequent to February 28, 1913. Appropriate entries were made in the corporation's books on account of the dividend, the surplus being decreased by $5,000 and the capital stock increased by the same amount. The question is whether such stock dividend was taxable income to the sole stockholder upon receipt thereof in 1936. The preferred stock has not been cancelled or redeemed by the corporation, nor has it been sold by the petitioner. The Board ruled that the stock dividend was taxable income.

In *Eisner* v. *Macomber*, 252 U. S. 189, it was held that a dividend payable in common stock to holders of common stock was not constitutionally taxable as income because

distribution of the dividend produced no change in the stockholders' proportionate interest in the corporation's net assets. Following this decision, Congress provided in section 201(d) of the Revenue Act of 1921 that a stock dividend was not taxable. 42 Stat. 228. This provision was reenacted in the later revenue acts until the case of *Koshland* v. *Helvering*, 298 U. S. 441, disclosed that certain stock dividends could be considered taxable income. The Revenue Act of 1936, enacted after the *Koshland* decision, provided in section 115(f), 49 Stat. 1688, as follows:

"(f) Stock Dividends.—

(1) General Rule—A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the [fol. 34] meaning of the Sixteenth Amendment to the Constitution."

It is implicit in this provision that Congress intended to tax stock dividends to the full extent of its constitutional power; and so the Regulations expressly declared. Art. 115-7, Reg. 94.

The question before us therefore comes down to whether a stock dividend in preferred stock to the sole owner of the common stock, which was the only class of stock outstanding, may be regarded as income within the meaning of the Sixteenth Amendment; in other words, whether the case is governed by *Eisner* v. *Macomber* or by *Koshland* v. *Helvering*. In the latter case at page 445 of 298 U. S. the court said:

"Under our decisions the payment of a dividend of new common shares, conferring no different rights or interests than did the old,—the new certificates, plus the old, representing the same proportionate interest in the net assets of the corporation as did the old,—does not constitute the receipt of income by the stockholder. On the other hand, where a stock dividend gives the stockholder an interest different from that which his former stockholdings represented he receives income. The latter type of dividend is taxable as income under the Sixteenth Amendment."

The *Koshland* case involved a dividend of common stock to preferred stockholders. In *Helvering* v. *Gowran*, 302 U. S.

238, the court considered a dividend of preferred stock to common stockholders. Mr. Justice Brandeis, speaking for the court, said, at page 241, that under the rule declared in the *Koshland* case Congress could have taxed this stock dividend. This expression of opinion would dispose of the [fol. 35] case at bar were it not for the fact that in the *Gowran* case, as in *Koshland*, there were two classes of stock outstanding when the dividend was declared; hence the stock dividend in each of those cases changed the stockholders' proportionate interests in the net corporate assets. Here, however, there was only one class of stock outstanding and but a single stockholder, who after, as before, the dividend owned the entire beneficial interest in the net assets of the corporation. Nevertheless the rearrangement of corporate capitalization so that the petitioner held preferred as well as common stock did change the character of his corporate ownership. The preferred stock had the prior right to dividends and a preference on liquidation of the corporation; and these rights could be disposed of without affecting the voting control residing in the common stock. The petitioner received property rights of actual and exchangeable value and representing an interest different from that which his common shares represented. As the Circuit Court of Appeals of the Seventh Circuit said in the *Gowran* case, 87 F. 2d 125, 127:

"The legal quality of what the taxpayer has after such distribution is different from that which he had before. Therefore the distribution is one of property rights of variant character from those which he previously owned, and as such, therefore, constitutes income which could be taxed."

See also *Commissioner* v. *Tillotson Mfg. Co.*, 76 F. 2d. 189 (C. C. A. 6); *Kelly Trust* v. *Commissioner*, 38 B. T. A. 1014 which was affirmed in an opinion (1939 C. C. H., Vol. 4, Par. 9624) later withdrawn, 106 F. 2d 1002 (C. C. A. 8). In our opinion the case at bar is governed by the *Koshland* principle rather than by that enunciated in *Eisner* v. *Macomber*. It must be conceded, however, that the question is not free from doubt. Certain commentators have ex- [fol. 36] pressed the opposite view. Mertens, Law of Fed. Income Taxation 1939, Cum. Supp. p. 295 *et seq.*; C. C. H. Standard Fed. Tax Service 1941, Vol. 2, p. 3096. Compare

also *Sprouse* v. *Commissioner*, 122 F. 2d 973 (C. C. A. 9). Order affirmed.

CHASE, *Circuit Judge* (dissenting):

I cannot help but think that my brothers have failed to give recognition and effect to the substance of the difference between *Koshland* v. *Helvering*, 298 U. S. 441 and *Eisner* v. *Macomber*, 252 U. S. 189.

If, after the receipt of a dividend paid in stock, a stockholder has not only additional stock but also stock of a different character his proportionate interest in the net assets of the corporation may have been changed where there are several, or more, stockholders. Whenever it has been and the change is by way of increase in his proportionate interest in the net value of the corporation there is a receipt of income which Congress has taxed. *Koshland* v. *Helvering* (*supra*), 298 U. S. 441. But surely the case just mentioned must rest upon firmer ground than a change in the kind of shares of stock a stockholder has as the result of a dividend of stock on stock. There must also be a change in his proportionate interest in the corporation's net assets in order to have what is known as a "realization" of income. When, as in this instance, there has been no such change for the simple reason that the stock dividend did not bring that about in the holdings of one who, both before and after it, owned exactly the same interest in the net value of the corporation, because he always owned it all, the real basis of decision in the *Koshland* case is lacking and that of *Eisner* v. *Macomber* (*supra*), 252 U. S. 189, does, I think, apply. See *Sprouse* v. *Commissioner*, 122 Fed. (2) 973.

I would reverse.

[fol. 37] UNITED STATES CIRCUIT COURT OF APPEALS, SECOND CIRCUIT

At a Stated Term of the United States Circuit Court of Appeals, in and for the Second Circuit, held at the United States Courthouse in the City of New York, on the 7th day of January one thousand nine hundred and forty-two.

Present: Hon. Thomas W. Swan, Hon. Augustus N. Hand, Hon. Harrie B. Chase, *Circuit Judges*.

EMIL H. STRASSBURGER, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

Appeal from the United States Board of Tax Appeals

This cause came on to be heard on the transcript of record from the United States Board of Tax Appeals, and was argued by counsel.

On Consideration Whereof, it is now hereby ordered, adjudged, and decreed that the order of said United States Board of Tax Appeals be and it hereby is affirmed.

It is further ordered that a Mandate issue to the said Board in accordance with this decree.

D. E. Roberts, *Clerk.*

[fol. 38] [Endorsed:] United States Circuit Court of Appeals, Second Circuit. Emil H. Strassburger v. Commissioner of Internal Revenue. Order for Mandate. United States Circuit Court of Appeals, Second Circuit. Filed Jan. 7, 1942. D. E. Roberts, Clerk.

[fol. 39] Clerk's Certificate to foregoing transcript omitted in printing.

[fol. 40] SUPREME COURT OF THE UNITED STATES

ORDER ALLOWING CERTIORARI—Filed May 11, 1942

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Second Circuit is granted.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

FILE COPY

Office - Supreme Court, U. S.
FILED
APR 3
CHARLES ELMORE CROPLEY
Clerk

IN THE

Supreme Court of the United States

OCTOBER TERM, 1941.

No. ~~1100~~ 66

EMIL H. STRASSBURGER,

Petitioner,

against

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT AND BRIEF IN SUPPORT THEREOF.

LEO BRADY,
Attorney for Petitioner.

MARK SERVICE, BARCLAY 7-2180

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1941.

No.

EMIL H. STRASSBURGER,

Petitioner,

against

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR WRIT OF CERTIORARI.

TO THE HONORABLE, THE CHIEF JUSTICE AND ASSOCIATE JUSTICES OF THE SUPREME COURT OF THE UNITED STATES:

The undersigned, on behalf of the above named Petitioner, prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Second Circuit entered in the above case on January 7, 1942, affirming the order of the United States Board of Tax Appeals which determined the presence of a deficiency in the 1936 income tax returns of petitioner.

Statement.

In the Circuit Court, two opinions were rendered, a majority opinion (per Swan, C. J., concurred in by Augustus N. Hand, C. J.—R. 32-35) and a dissenting opinion (per Chase, C. J.—R. 35). The judgment entered thereon (R. 36) affirmed the order of the Board of Tax Appeals (R. 17).

The facts (R. 12-14) were stipulated substantially as follows:

Petitioner resides in New York, New York.

E. H. Strassburger, Inc., sometimes hereinafter referred to as the Corporation, is a New York corporation organized in or about January, 1932, with its principal place of business at 740 Broadway, New York, New York.

On December 10, 1936, the authorized capital stock of the Corporation consisted of 200 shares of common stock with exclusive voting rights. All of this stock was owned by petitioner.

On December 11, 1936, the Corporation's articles of incorporation were duly amended for the creation and authorization of an issue of 500 shares of $100 par value, 7 per cent, cumulative, non-voting preferred stock.

On December 21, 1936, the board of directors of the Corporation held a meeting at which a resolution was adopted of which the following is material:

> "Now, Therefore, Be It Resolved, that for the purpose of representing in the capitalization of this corporation surplus assets to the extent of Five Thousand Dollars, a distribution among stockholders of the capital stock of the corporation be made of Five Thousand Dollars of preferred capital stock, and the proper officers of the corporation are hereby authorized and directed to issue an aggregate of Five Thousand Dollars, par value of preferred capital stock of this corporation, in payment of a stock dividend on the common stock of this corporation.
>
> "Further Resolved, that the directors of this corporation be authorized to distribute said Five Thousand Dollars of the preferred capital stock, pro rata, among stockholders, as and for a stock dividend on said capital stock so owned by them, such distribution to be made to stockholders of record at the close of business on December 24, 1936."

On December 24, 1936, pursuant to the resolution adopted on December 21, 1936, 50 shares of preferred stock of the Corporation were issued to petitioner, the sole common stockholder. At the time of the distribution of the stock dividend the Corporation had earnings and profits accumulated subsequent to February 28, 1913, in excess of $5,000. Appropriate book entries were made on account of the dividend, decreasing the surplus of the Corporation by $5,000 and increasing its capital stock in the same amount.

On December 29, 1936, the 50 shares of preferred stock which petitioner had received as a dividend were transferred to his wife, Gertrude W. Strassburger. Upon her death the shares were retransferred to petitioner who is now the record holder. No dividends have been paid on the preferred stock and that stock has never been disposed of, cancelled or retired.

(Agreed Statement of Facts, R. 25-28).

Jurisdiction.

The judgment of the Circuit Court of Appeals was entered January 7, 1942 (R. 36). The jurisdiction of THIS COURT is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925 (43 Stat. 938, U. S. C. A. Title 28, Section 347 (a)).

The Question Presented.

Whether a stock dividend in preferred stock, declared by a corporation which had only a single class of stock outstanding—common—all owned by one person, may, on its receipt by him, be regarded as income within the meaning of the Sixteenth Amendment and be subjected to tax under Section 115 (f) of the Revenue Act of 1936, c. 690, 49 Stat. 1688.

Specification of Errors.

The errors presented for review, along with the question above, are set forth on pages 6-7 herein, and we request that said specification of errors be deemed incorporated in this Petition.

Reasons for Granting the Writ.

1. The question presented herein is an important question of federal law which, so far as our research has revealed, has not been directly settled, but should be so settled, by THIS COURT.

2. The majority opinion of the Circuit Court concludes with this pertinent observation: "It must be conceded, however, that the question [presented herein] is not free from doubt" (R. 34).

3. The decision of the Circuit Court is in direct conflict with the decisions of other Circuit Courts on the same matter. *Sprouse* v. *Commissioner of Internal Revenue*, 122 Fed. (2d) 973 (C. C. A. 9th, 1941), cert. den. March 2, 1942; *Clark* v. *Commissioner*, 77 Fed. (2d) 89 (C. C. A. 3rd, 1935), aff'g. 28 B. T. A. 1225; *Commissioner* v. *Brown*, 69 Fed. (2d) 602 (C. C. A. 7th, 1934), aff'g. 26 B. T. A. 901.

THIS COURT, as recently as March 2, 1942, denied the Commissioner's petition for certiorari in the *Sprouse* case (*supra*). The *Sprouse* case held that the real test to be used in determining whether the stockholder who received a dividend of stock in the same corporation has received taxable income, is whether the distribution effects a change in the proportionate interest of the stockholders.

In the instant case, the majority opinion (R. 34) has held that payment of a dividend in preferred stock to the sole stockholder of all the outstanding common stock has resulted in a rearrangement of the corporate capitalization and has changed the character of the sole stockholder's corporate ownership. The sole stockholder is adjudged to have received property rights of actual and exchangeable value and representing an interest different from that which his common shares represented, despite the cardinal fact that both before and after the stock

dividend the sole stockholder actually owned the entire interest in the net value of the corporation.

4. The majority opinion of the Circuit Court is in direct conflict with the principle underlying the decision of THIS COURT in *Eisner* v. *Macomber* (252 U. S. 189.) THIS COURT there held that a dividend payable in common stock to the holders of common stock, there being one class of stock then outstanding, was not constitutionally taxable as income because distribution of the dividends produced no change in the stockholders' proportionate interest in the corporation's net assets.

5. The dissenting opinion of Chase, C. J. (R. 35) should be considered by THIS COURT and sustained for guidance in future similar circumstances.

6. Definitively to settle the law applicable to this and other cases now pending in other courts and involving the same question.

WHEREFORE, your petitioner respectfully prays that a writ of certiorari be issued in the above-named cause under the seal of this Court directed to the United States Circuit Court of Appeals for the Second Judicial Circuit, City of New York, New York, commanding said Court to certify and send to this Court on a day to be designated, a transcript of the record and all proceedings had in such a cause, to the end that such judgment referred to at page 1 hereof may be reviewed and determined by this Court; that said judgment may be set aside and reversed, and that petitioner be granted such other and further relief as may be just and proper.

Dated, New York, N. Y., March 20, 1942.

LEO BRADY,
Attorney for Petitioner,
165 Broadway,
New York, New York.

BRIEF IN SUPPORT OF PETITION.

Opinions Below.

The opinion of the Board of Tax Appeals (R. 14-17) is reported in 43 B. T. A. 1209 (memorandum).

The opinions of the Circuit Court of Appeals (majority opinion, R. 32-35, minority opinion, R. 35) are reported in 124 Fed. (2d) 315-317.

Jurisdiction.

The judgment of the Circuit Court of Appeals was entered January 7, 1942 (R. 36). The jurisdiction of THIS COURT is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925 (43 Stat. 938, U. S. C. A. Title 28, Section 347 (a)).

Statement.

The material facts are set forth in the Petition at pages 1-3.

Statute Involved.

The statute involved is Section 115 (f) of the Revenue Act of 1936, c. 690, 49 Stat. 1688, and Art. 115-7 of Reg. 94 promulgated by the Commissioner of Internal Revenue.

Specification of Errors.

The errors which petitioner will urge if the writ of certiorari is allowed are that the Circuit Court erred—

1. In holding that the receipt by petitioner of a dividend in preferred stock paid by E. H. Strassburger, Inc., which had only a single class of common stock outstanding, all of which was owned by petitioner, constituted taxable income.

2. In holding that the preferred stock dividend

   (a) gave petitioner rights different from those which he possessed before;

   (b) materially affected or changed the character of petitioner's corporate ownership;

(c) conferred upon petitioner property rights of actual and exchangeable value and representing an interest different from that which his common shares represented, and therefore gave rise to taxable income.

3. In holding that the petitioner received taxable income in the amount of the fair market value of the preferred stock dividend, resulting in a deficiency in income tax due by petitioner.

4. In failing to hold that there was no change in petitioner's proportionate interest in the corporation.

5. In failing to determine that the tax liability imposed upon petitioner is without warrant either under the United States Constitution, the Federal Statutes or the Regulations, with respect to the taxation of income thereunder.

6. In failing to determine that the Statutes and Regulations, insofar as the same may purport to tax the preferred stock dividend in question, are illegal, unconstitutional or void for want of certainty, clarity and definiteness and impose no tax basis or formunla for the computation of tax liability.

7. In affirming the decision of the Board of Tax Appeals.

Summary of Argument.

The receipt by petitioner of a dividend in preferred stock paid by E. H. Strassburger, Inc. which had only a single class of common stock outstanding, all of which was owned by petitioner, does not constitute taxable income within the meaning of the Sixteenth Amendment.

ARGUMENT.

POINT I.

The mere receipt of the stock dividend in question does not under the constitution, statutes or regulations constitute taxable income to the petitioner; any attempt so to impose such tax is unconstitutional and void.

Prior to 1936 all stock dividends were specifically made exempt from tax by statute; constitutionally, various stock dividends could not be taxed inasmuch as such stock dividends did not constitute taxable income.

Eisner v. *Macomber*, 252 U. S. 189.

It goes without saying that all income is not income subject to tax under the Sixteenth Amendment to the Constitution of the United States.

The statutory provision and the regulation upon which the Commissioner relies are as follows:

Revenue Act of 1936, c. 690, 49 Stat. 1688:

"Sec. 115 (f) Stock Dividends.

(1) General Rule: A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution."

"Art. 115-7 [Reg. 94] Stock Dividends.—A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall be treated as a dividend to the full extent that it constitutes income to the shareholders within the meaning of the Sixteenth Amendment to the Constitution. * * * The distinction between a stock dividend which does not, and one which does, constitute in-

come to the shareholder within the meaning of the Sixteenth Amendment to the Constitution is the distinction between a stock dividend which works no change in the corporate entity, the same interest in the same corporation being represented after the distribution by more shares of precisely the same character, and a stock dividend where there either has been a change of corporate identity or a change in the nature of the shares issued as dividends whereby the proportional interest of the shareholder after the distribution is essentially different from his former interest. A stock dividend constitutes income if it gives the shareholder an interest different from that which his former stock holdings represented. A stock dividend does not constitute income if the new shares confer no different rights or interests than did the old—the new certificate plus the old representing the same proportionate interest in the net assets of the corporation as did the old."

We believe that the Regulation squarely covers the instant case and makes the dividend non-taxable. In examining the Congressional purpose and intention we find the following discussion in connection with the Revenue Act of 1936, reported in the Congressional Record, Volume 80, Part 6, pp. 6214-15:

"Coming now to stock dividends, this is a field that has more or less been surrounded with mystery. Existing law provides that no tax shall be levied upon stock dividends. We strike that from this bill. * * *

"The kind of securities issued and the change in the proportion of ownership of a person in a corporation are the determining factors as to whether or not it is taxable income under the 16th amendment. * * *

* * *

"As we see it, a stock dividend that is not taxable is one in which the relative interest of each shareholder of a corporation is unchanged in his stock ownership. * * *

"There are, however, many instances in which dividends in stocks or bonds are issued which are realized taxable incomes under the 16th amendment. The yardstick of ownership in many cases is changed —that is, the relative proportion of ownership in the corporation by a shareholder is increased or decreased.

* * * p. 6309:

"The proposed plan does not change the law and does not in the slightest degree strike at the decision of the Supreme Court in the case of *Eisner* v. *Macomber* in respect of a stock dividend where there is no change in the proportion of ownership by the shareholder."

Editorial comment is to the same effect. In Commerce Clearing House, Standard Federal Tax Service, 1941, Vol. 2, at p. 3096, the Editors say:

"If there is only one class of stockholders at the time of the issuance of additional stock to all the stockholders, any dividend paid to all such stockholders in stock of the paying corporation, whether paid in common or preferred stock, would appear to be exempt under Section 115 (f), for the dividend results in no change in the proportionate interest of each stockholder in the earnings or in the assets of the corporation. * * *"

Nothwithstanding several reported decisions relied upon by Respondent which appear to justify the imposition of tax the Editors make the following significant observation: "Under the Act of 1936 and later Law such divi-

dend would be taxable if there was other stock outstanding at the time of the dividend which did not receive a pro rata distribution." In other words where the outstanding stock did not share proportionately in the stock dividend then the Editors contend that the dividend would be taxable; however, where all outstanding stock received a proportionate stock dividend, said dividend would not be taxable.

Perhaps the most thoroughgoing of all of the Board decisions on the subject is the case of *Horrmann, et al.*, 34 B. T. A. 1178. To the extent that the decision written by Board Member Arundell is pertinent to the instant case, we quote from page 1182 thereof:

> "* * * The dividend in *Eisner* v. *Macomber, supra*, was in common stock on stock of the same kind; here, it is in preferred stock on common stock, which was the only class outstanding. We held in *Pearl B. Brown, Executrix*, 26 B. T. A. 901; affd., 69 Fed. (2d) 602, that a dividend like the present one, namely, in preferred stock on common, where only common was outstanding, was a pure stock dividend 'constitutionally free from tax', following *Eisner* v. *Macomber, supra*. We said that its effect was 'a mere proliferation of existing interests'. Further:
>
> "'At the moment of change, each shareholder's proportionate rights were absolutely and relatively the same, except that each in the same ratio had preferred as well as common shares, a difference without significance here. These are the essential characteristics of a stock dividend—those which have always given point to the cases in which the question has arisen. *Gibbons* v. *Mahon*, 136 U. S. 549; *Towne* v. *Eisner*, 245 U. S. 418; *Eisner* v. *Macomber*, 252 U. S. 189; *La Belle Iron Works* v. *United States*, 256 U. S. 377; see also *Graves* v. *Graves*, 120 Atl. 420; *Kaufman* v. *Charlottesville Co.*, 23 S. E. 1003; *United States* v. *Siegel*, 52 Fed. (2d) 63.'"

After citing various other cases holding similarly because there was no severance of assets from the declarant corporations and because the stockholders' proportionate interest remained unchanged, the Board at pp. 1182-3 continued:

> "We do not believe that the recent case of *Koshland* v. *Helvering*, 297 U. S. 702,* requires a different conclusion. The facts there were different in that both common and preferred stock were outstanding when a dividend on the preferred was paid in common stock. There is, as pointed out in the *Koshland* decision, a distinction between cases like the *Macomber* case and those where 'the proportional interests of the stockholder after the distribution was essentially different from his former interest.
>
> "'* * * Where a stock dividend gives the stockholder an interest different from that which his former stock holdings represented, he receives income'. The quoted words state the theory upon which the Board and the Circuit Court of Appeals proceeded in *Tillotson Manufacturing Co.*, 27 B. T. A. 913; affd., 76 Fed. (2d) 189. In that case there were both common and preferred stock outstanding when the dividend on the preferred was paid in common stock. * * *"

It should be noted that Congress and the Courts have heretofore established as prerequisite to the taxability of a stock dividend that the interest be essentially different, substantially different.

We observe, running through the entire Congressional, editorial and judicial discussions, the controlling criterion or determining factor, namely, the stockholder's relative proportion of ownership in the corporation. Indeed in the Congressional discussions it has been called the yardstick, and the change in the law by the 1936 Act is stated

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* *Sic*—298 U. S. 441.

not to strike at the decision in *Eisner* v. *Macomber*, *supra*, "in respect of a stock ownership where there is no change in the proportion of ownership by the shareholder." In the *Horrmann* case, as here, the Board held that the dividend was a pure stock dividend "constitutionally free from tax".

The Board of Tax Appeals cited several cases, to wit: *John M. Keister*,* 42 B. T. A. 484; *Koshland* v. *Helvering*, 298 U. S. 441; *Frank J. and Hubert Kelly Tvast*, 38 B. T. A. 1014, remanded 106 Fed. (2d) 1002; *Albert E. Smith*, 39 B. T. A. 80. Those cases do not all involve the issue here presented but rather concern the basis for computing tax. Moreover we respectfully submit that the *Koshland* case, fairly interpreted, is no support for the imposition of tax herein. If indeed it should be held that the Board cases hereinabove noted are inconsistent with the principle which we urge, then we respectfully submit that those cases are wrong. There is no Circuit Court of Appeals decision supporting any of the said Board cases except the decision below; indeed the authority is to the contrary.

Sprouse v. *Commissioner*, 122 Fed. (2d) 973, (C. C. A. 9th) is the case supporting our contention and opposed to the holding of the Circuit Court in the case at bar. The Commissioner's application for certiorari was denied by this Court on March 2, 1942.

The court below, after reviewing the facts and the law, discusses the *Koshland* case, *supra*, (R. 34) and concludes that the dividend in question paid to the petitioner herein constituted taxable income. The Court then quotes the following, (R. 33) from the *Koshland* case:

> "'Under our decisions the payment of a dividend of new common shares, conferring no different rights or interests, than did the old,—the new certificates, plus the old, representing the same proportionate interest in the net assets of the corporation as did the

* Reversed under name of *Sprouse* v. *Commissioner*, *supra*.

old,—does not constitute the receipt of income by the stockholder. On the other hand, where a stock dividend gives the stockholder an interest different from that which his former stockholdings represented he receives income. The latter type of dividend is taxable as income under the Sixteenth Amendment.'"

In the *Koshland* case, however, both preferred and common stock were outstanding at the time that the common stock dividend was declared in favor of preferred stockholders. This fact, in the words of the Court below, is stated as follows (R. 34):

> "This expression of opinion would dispose of the case at bar were it not for the fact that in the *Gowran* case, as in *Koshland*, there were two classes of stock outstanding when the dividend was declared; hence the stock dividend in each of those cases changed the stockholder's proportionate interests in the net corporate assets. Here, however, there was only one class of stock outstanding and but a single stockholder, who after, as before, the dividend owned the entire beneficial interest in the net assets of the corporation."

Why this all important fact noted by the Circuit Court as the real difference between the *Koshland* case and the case at bar, was not definitive, it is difficult to understand. In the words of the Court, the following is the explanation (R. 34):

> "'Nevertheless, the rearrangement of corporate capitalization so that the petitioner held preferred as well as common stock did change the character of his corporate ownership. * * *'"

Frankly, we do not understand what the Court means by the character of the petitioner's ownership. Indeed, the true character of petitioner's ownership in the corporation was the entire ownership of the equity, and it is

immaterial whether that equity is reflected by shares of preferred stock or shares of common stock or both. The Court in the *Sprouse* case, *supra*, held that the true test was "whether the distribution effects a change in the proportionate interest of the stockholders." An entire interest can only be decreased, it may never be increased, and no abstruse metaphysics can change that simple fact of arithmetic.

The Court below further pointed out (R. 34) that the preferred stock had prior right to dividends and a preference on liquidation, and that these rights could be disposed of without affecting the voting control residing in the common stock (R. 34). Suffice it to answer that such difference is one of form and not of substance in view of the fact that all of the equity rested before and still rests with the petitioner.

Moreover, it is unimportant that prefered stock may be disposed of without affecting voting control, for the sole common stockholder may likewise dispose of a portion of his common stock without affecting voting control. But *Eisner* v. *Macomber*, *supra*, holds that a dividend of common on common is not taxable.

Further, if the theory of the tax were to prevent tax avoidance, which is not urged and which is not in issue, the law clearly covers such situation, for under Section 115 (g) of the Revenue Act of 1936 the cancellation, redemption or retirement of preferred stock is made taxable.

Viewed from every conceivable angle and analyzed with every conceivable theory in mind, there still appears no justifiable basis for the imposition of tax liability.

To justify the tax in the instant case the Court below seized upon the statement in the *Koshland* case which sustained the imposition of tax because the shares received by the recipient gave him a "different" interest. However, the word "different" means a difference in substance and not a difference in form and was so used

in the *Koshland* case. The whole principle of our Constitution preventing discrimination requires that the difference be one of substance. Were it not so, the classic school room examples of the red-headed man and the odd necktie would be sufficient to justify different discriminatory taxes and discriminatory treatment.

Rather do we urge as the sound and correct determination of the question presented the minority opinion of the Court below (R. 35), which requires as prerequisite to taxable income the increase in the stockholder's proportionate interest in the net value of the corporation. This simple criterion is, we submit, the true meaning of *Koshland* v. *Helvering*. Indeed, the language used fairly permits no other meaning.

Doubt existed as to the correctness of the decision even in the minds of the majority below for it concluded its opinion as follows (R. 34):

> "It must be conceded, however, that the question is not free from doubt. * * *"

If a "different interest" meant literally what the majority stated it meant, then even in *Eisner* v. *Macomber* stock dividend would be taxable, because the stockholder after the dividend held two pieces of paper where formerly he had only one piece of paper; he had something different, but of course, this difference was not of substance. An understanding of the nature and background of stock dividends makes clear what this Court meant in *Koshland* v. *Helvering* when it spoke of a different interest, if indeed, the language itself were not sufficiently clear, as we submit it was.

Further, the Treasury Department itself interpreted the question correctly, and in support of the petitioner. In Article 115-7 of Regulations 94, set forth on pages 8-9 herein, it appears that the word "different" as used in the *Koshland* case means different in substance, a change in the stockholder's proportionate interest. This obvious

point has already been noted herein, and need not be labored.

While the Treasury Department has since eliminated practically all of Article 115-7 from the current regulations, it remains unchanged in Regulations 94 applicable to the instant case, and the change shows a significant contemporaneous construction of the Statute by those charged with the enforcement thereof.

The facts of the *Sprouse* case, *supra*, are similar to the facts in the instant case. There the only stock outstanding was common, voting and non-voting. Stock dividends in non-voting common and in 7% cumulative preferred were declared payable to the voting and non-voting common stockholders. After discussing the facts and the meaning of the word "income" the Court (C. C. A. 9th), at page 976, made the following pertinent observations:

> "Generally, insofar as the stockholder is concerned, the three main differences in stocks are in the rights (1) to an interest in the assets of the corporation, the differences being in the amount of such interest and the preference it may have over other interests in the corporation; (2) to dividends, the differences being in the absoluteness of the right, and whether such right is cumulative; and (3) to manage and control the corporate venture by voting.
>
> "The Board was of the view, as appellee argues here, that if the stock distributed as a dividend, differed in its nature from that held by the stockholder, the latter derived income. In other words, differences in such characteristics as preference in interest in the assets and in dividends, and the right to vote, are proposed as the test to determine whether the recipient of the stock dividend has derived income. We think such a test results from a misconstruction of the decisions of the Supreme Court.
>
> • • •

"Where the corporation has more than one class of stock outstanding, and distributes a stock dividend to one class only, then the proportionate interests in the corporation are changed, because the class of stockholders who receive the dividend then have a greater interest in the assets of the corporation than those who did not receive the stock dividend. There being a change in the proportionate interests, the recipients of the stock dividend have derived income.

* * *

"Therefore, we believe the real test to be used in determining whether the stockholder who receives a dividend of stock in the same corporation has received income, is whether the distribution effects a change in the proportionate interest of the stockholders."

It should be noted that the sound body of law prior to the decision in the *Koshland* case held that the dividend in question was not taxable. We have already pointed out that even after the *Koshland* case, the Board decided in the *Horrmann* case that the dividend was still not taxable, which decision is now supported by the *Sprouse* decision, *supra*, certiorari denied.

Horrmann, et al., 34 B. T. A. 1178, discussed the facts and distinguished the *Koshland* case from the one there under consideration. The Board, at page 1182, says of the *Koshland* case:

"The facts there were different in that both common and preferred stock were outstanding when a dividend on the preferred was paid in common stock.

* * *"

Among various other cases supporting the *Horrmann* case are:

Commissioner v. *Brown*, 69 Fed. (2d) 602 (C. C. A. 7th, 1934), aff'g. 26 B. T. A. 901;

Clark v. *Commissioner*, 77 Fed. (2d) 89 (C. C. A. 3rd, 1935), aff'g. 28 B. T. A. 1225.

Moreover, in the instant case we are dealing with but a single stockholder who had no more and no less after the stock dividend than before. Irrespective of nice reasoning, the simple fact is that the petitioner neither in theory nor in law received taxable income upon the receipt of the stock dividend.

POINT II.

Apart from the Sixteenth Amendment, the statute and regulation, if they purport to impose income tax, are void as a matter of construction as well as constitutionality.

It is one of the elementary canons of taxation that a tax statute must be certain, clear and definite. Particulary is this true where penalties and imprisonment may be imposed for violation thereof. As heretofore pointed out the Statute does not, under the Sixteenth Amendment, impose an income tax on the stock dividend in question. However, if it should be so construed to impose a tax, then we respectfully submit that it is void as a matter of construction as well as constitutionality. What has Congress said to fix tax liability herein sought to be imposed? It has said that if the dividend is constiutionally taxable it may be taxed. The Sixteenth Amendment said as much, but certainly no one could soundly argue that taxes could be imposed and collected on the strength of a mere declaration that everything that is constitutionally taxable must be included in a taxpayer's return and that a failure would result in severe pains and penalties. A declaration of purpose or policy is not a tax law. A statute which requires a taxpayer at his risk to be a constitutional lawyer appears hopelessly invalid.

How shall the Courts construe the amendment if not in the light of what the framers of the Statute said?

They said, as we have shown before, that the stock dividend in question received by the petitioner herein is not taxable and was not intended to be taxed, even after the change in 1936. They said that they wanted to extend the tax to cover cases permitted by the decision of *Eisner* v. *Macomber, supra,* but that the instant case was not one of the cases which could constitutionally be affected.

We submit, further, that even if the Supreme Court of the United States should decide that the stock dividend received by the petitioner is constitutionally taxable, notwithstanding *Eisner* v. *Macomber,* that the dividend still would not be subject to tax because Congress under the 1936 Act accepted as the controlling constitutional criterion the Supreme Court decision in *Eisner* v. *Macomber* and not the decision of the Supreme Court in any other case. Therefore, as a matter of construction stock dividends constitutionally subject to tax are such dividends which the Supreme Court had in *Eisner* v. *Macomber* permitted to be taxable. Even assuming for the sake of the argument that Congress could sweep aside all standards and permit tax to be imposed on the basis of what is now constitutional, Congress has not yet done so and the Courts ought not to extend legislation beyond its clear Congressional limits.

In view of the foregoing, it is respectfully submitted that the receipt of the preferred stock dividend by the petitioner did not constitute taxable income.

Conclusion.

For the reasons herein assigned, it is respectfully submitted that the case is one which justifies the issuance of a writ of certiorari.

Respectfully submitted,

LEO BRADY,
Attorney for Petitioner.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1941.

No. ~~1100~~. 66

EMIL H. STRASSBURGER,

Petitioner,

against

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITIONER'S REPLY BRIEF.

In order fully to apprise the Court of all developments to date in the above entitled cause, we respectfully invite the attention of the Court to the case of *Dreyfuss* v. *Manning, Collector,* Fed. Supp. , District Court of New Jersey, March 24, 1942. Said decision has not yet been officially reported, but appears in the report of April 15, 1942, Commerce Clearing House, Standard Federal Tax Service, 1942, ¶9399. Particularly do we note this case since Respondent's brief makes no mention of or reference thereto. In the *Dreyfuss* case on substantially identical facts, District Judge Fake specifically adverted to the Strassburger case, but refused to follow the majority decision therein. After a thorough-going analysis of the principles of law underlying the whole question of taxability of stock dividends from *Eisner* v. *Macomber* down to date, including the *Koshland* case, the Court concluded that the true criterion depends upon whether the taxpayer's proportionate interest in the net assets had been increased. The facts showed, observed the Court, that the sole stockholder had a 100% interest before the

stock dividend and a 100% interest after the stock dividend and that no income had been realized.

> "To reason to the contrary, makes it necessary to arrive at the conclusion that the whole can be greater than the sum of its parts. Even in this advanced age, wherein thought is being tested by science and invention, no such feat as yet has been accomplished."
>
> • • •
>
> "In *Strassburger* v. *Commissioner*, 124 F. (2d) 315, the majority opinion is in direct conflict with the result arrived at here, but it should be noted that the opinion concedes that 'the question is not free from doubt.' Judge Chase, in dissenting, says 'But surely the case just mentioned (the *Koshland* case) must rest upon firmer ground than a change in the kind of shares of stock a stockholder has as the result of a dividend of stock on stock. There must also be a change in his proportionate interest in the corporation's net assets in order to have what is known as a "realization" of income.' With this dissent I find myself in full accord for the reasons above stated."

Further, the Circuit Court of Appeals in the 9th Circuit which decided the *Sprouse* case, has followed its decision in *Keister* v. *Commissioner*, Fed. (2d) , April 10, 1942, not yet reported but appearing in Commerce Clearing House, Standard Federal Tax Service, 1942, ¶9423.

Respondent opposes the granting of the petition. In effect opposing counsel say that although they thought that the entire question should be reviewed and so urged in the *Sprouse* petition, since this Court denied said petition, it ought also to deny this petition. It may well be, however, that this Court saw no reason to upset the decision in the *Sprouse* case and would not grant certiorari

until the proper case was presented. We respectfully submit, in view of the decision below and the uncertainty in the lower Courts as evidenced by the conflicting decisions, that the instant case is a proper case for review, and again we respectfully request that the petition be granted.

Respectfully submitted,

LEO BRADY,
Attorney for Petitioner.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1942.

No. 66.

EMIL H. STRASSBURGER,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.

BRIEF FOR THE PETITIONER.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1942.

EMIL H. STRASSBURGER,
Petitioner,
vs.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

No. 66.

BRIEF FOR THE PETITIONER.

Opinions Below

The majority and dissenting opinions of the Circuit Court of Appeals, Second Circuit, are officially reported in 124 Fed. (2d) 315; the memorandum opinion of the United States Board of Tax Appeals is not officially reported but is noted in 43 B. T. A. 1209.

Jurisdiction

The judgment of the Circuit Court of Appeals was entered January 7, 1942 (R. 36). Petition for a writ of certiorari was filed on April 3, 1942 and granted on May 11, 1942. The jurisdiction of THIS COURT is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925 (43 Stat. 938, U. S. C. A. Title 28, Section 347 (a)).

The grounds on which the jurisdiction of THIS COURT is invoked are:

1. The question presented herein is an important question of federal law which, so far as our research has revealed, has not been directly settled, but should be so settled, by THIS COURT.

2. The majority opinion of the Circuit Court concludes with this pertinent observation with respect to the issue presented: "It must be conceded, however, that the question is not free from doubt" (R. 34)

In the instant case, the majority opinion (R. 34) held that payment of a dividend in preferred stock to the sole stockholder of all the outstanding common stock resulted in a rearrangement of the corporate capitalization and changed the character of the sole stockholder's corporate ownership; that the sole stockholder received property rights of actual and exchangeable value and representing an interest different from that which his common shares represented. Even assuming such to be the facts, the taxpayer did not realize income and the cardinal fact remains that both before and after the stock dividend the sole stockholder actually owned the entire interest in the net value of the corporation.

3. The decision of the Circuit Court is in direct conflict with the decisions of other Circuit Courts on the same matter. *Sprouse* v. *Commissioner of Internal Revenue*, 122 Fed. (2d) 973 (C. C. A. 9th, 1941), cert. den. March 2, 1942, rehearing den. March 30, 1942, cert. granted May 11, 1942; *Clark* v. *Commissioner*, 77 Fed. (2d) 89 (C. C. A. 3rd, 1935), aff'g. 28 B. T. A. 1225; *Commissioner* v. *Brown*, 69 Fed. (2d) 602 (C. C. A. 7th, 1934), aff'g. 26 B. T. A. 901, cert. den. 293 U. S. 570.

4. The majority opinion of the Circuit Court is in direct conflict with the principle underlying the decision of THIS COURT in *Eisner* v. *Macomber*, 252 U. S. 189. THIS COURT there held that a dividend payable in common stock to the holders of common stock, where only one class of stock was outstanding, was not constitutionally taxable as income because distribution of the dividend produced no change in the stockholders' proportionate interest in the corporation's net assets.

5. The dissenting opinion of Chase, C. J. (R. 35) should be considered by THIS COURT inasmuch as it correctly applies the principles established by THIS COURT.

6. Definitively to settle the law applicable to this and other cases now pending in other courts and involving the same question.

Statement of the Case

This case is presented to this Court upon order allowing certiorari to the Circuit Court of Appeals, Second Circuit (R. 36). Said Circuit Court of Appeals by judgment affirmed an order of the United States Board of Tax Appeals upholding the Commissioner's determination of tax liability (R. 36, 17).

The issues involved were not disputed and were presented to the Board on an agreed Statement of Facts (R. 12-14, 25-28).

Briefly, the facts are:

Petitioner on December 10, 1936, owned all of the stock consisting of 200 shares of common of the Corporation, E. H. Strassburger, Inc.

On December 11, 1936, the Corporation's articles of incorporation were duly amended for the creation and authorization of an issue of 500 shares of $100 par value, 7 per cent, cumulative, non-voting preferred stock.

On December 21, 1936, the board of directors of the Corporation held a meeting at which a resolution was adopted of which the following is material:

> "NOW, THEREFORE, BE IT RESOLVED, that for the purpose of representing in the capitalization of this corporation surplus assets to the extent of Five Thousand Dollars, a distribution among stockholders of the capital stock of the corporation be made of Five Thousand Dollars of preferred capital stock,

and the proper officers of the corporation are hereby authorized and directed to issue an aggregate of Five Thousand Dollars, par value of preferred capital stock of this corporation, in payment of a stock dividend on the common stock of this corporation.

"FURTHER RESOLVED, that the directors of this corporation be authorized to distribute said Five Thousand Dollars of the preferred capital stock, pro rata, among stockholders, as and for a stock dividend on said capital stock so owned by them, such distribution to be made to stockholders of record at the close of business on December 24, 1936."

On December 24, 1936, pursuant to the resolution adopted on December 21, 1936, 50 shares of preferred stock of the Corporation were issued to petitioner, the sole common stockholder who thereby became the sole preferred stockholder as well. At the time of the distribution of the stock dividend the Corporation had earnings and profits accumulated subsequent to February 28, 1913, in excess of $5,000. Appropriate book entries were made on account of the dividend, decreasing the surplus of the Corporation by $5,000 and increasing its capital stock in the same amount.

The single question is whether the so-called stock dividend, upon its mere receipt by petitioner, has been by law subjected to income tax and further, irrespective of the law, whether the same constitutionally may be subjected to income tax.

Specification of Assigned Errors to be Urged by Petitioner

The Court below erred:

1. In holding that the receipt by petitioner of a dividend in preferred stock paid by E. H. Strassburger,

Inc., which previously had only common stock outstanding, all of which was owned by petitioner, constituted taxable income.

2. In holding that the preferred stock dividend

(a) gave petitioner rights different from those which he possessed before;

(b) materially affected or changed the character of petitioner's corporate ownership;

(c) conferred upon petitioner property rights of actual and exchangeable value and representing an interest different from that which his common shares represented, and therefore gave rise to taxable income.

3. In holding that the petitioner received taxable income in the amount of the fair market value of the preferred stock dividend, resulting in a deficiency in income tax due by petitioner.

4. In failing to hold that there was no change in petitioner's proportionate interest in the corporation.

5. In failing to determine that the tax liability imposed upon petitioner is without warrant either under the United States Constitution, the Federal Statutes or the Regulations, with respect to the taxation of income thereunder.

6. In failing to determine that the Statutes and Regulations, insofar as the same may purport to tax the preferred stock dividend in question, are illegal, unconstitutional or void for want of certainty, clarity and definiteness and impose no tax basis or formula for the computation of tax liability.

7. In affirming the decision of the Board of Tax Appeals and holding that under the facts before the Court the taxpayer received taxable income.

Summary of Argument

The receipt by the petitioner, Emil H. Strassburger, of a dividend in preferred stock of E. H. Strassburger, Inc., which corporation previously had only common stock outstanding, all of which was owned by petitioner Emil H. Strassburger, does not constitute taxable income under the Federal statutes, regulations or Constitution.

The entire interest in the assets of the corporation represented by stock of the corporation, was owned by petitioner. He could never own, in fact or in law, anything more than the whole. The declaration of a preferred stock dividend may have changed *the evidence of* his ownership or interest in the corporation; it did not and could not, however, affect or change that ownership or interest.

Neither legalism nor abstruse principles of accountancy can possibly alter the simple fact here involved in the issue before this Court. In numerous cases this Court has held that fact and not fiction controls, whether it be for determining income or any other substantive right. Even if there were a wholesome purpose to be served by the attempted overthrow of fundamental law, the end would be wholly unjustified. But here there is no such purpose. Theoretically, the Government may collect taxes at an earlier date than the same could otherwise be collected, but the problem would not stop there. For even the Treasury Department must admit that if gains are realized by a fictitious increase in a stockholder's interest in corporate assets, similarly, a loss is suffered by a stockholder's decrease in such interest. In reality, of course, neither gain nor loss is realized.

Apart from the question of the constitutionality of such

a tax, the statute has not attempted to impose any such tax. Congress made clear that the determining guide for the taxability of stock dividends was *Eisner* v. *Macomber*, 252 U. S. 189, and not *Koshland* v. *Helvering*, 298 U. S. 441, or any other case. In other words, Congress said in so many words that if a stock dividend can be taxed under the principles of the *Eisner* case, it shall be taxed, but Congress did not say that any other decision could serve as the test for determining taxability.

Further, the statute, if it should be construed to warrant the tax, is vague, indefinite and uncertain, and in view of the fact that it imposes penalties for its violation, is clearly unconstitutional.

Statutes Involved

The statute involved is Section 115 (f) of the Revenue Act of 1936, c. 690, 49 Stat. 1688, and Art. 115-7 of Reg. 94 promulgated by the Commissioner of Internal Revenue.

* * * * *

Sec. 22. Gross Income.

(a) General Definition.—"Gross income" includes gains, profits, and income derived from * * * dividends, * * *

* * * * *

Sec. 115. Distributions by Corporations.

(a) Definition of Dividend.—The term "dividend" * * * means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year * * *

* * * * *

Revenue Act of 1936, c. 690, 49 Stat. 1688:

Sec. 115 (f) relating to stock dividends and ART. 115-7 (Reg. 94) thereunder are set forth in full on this and the following page.

ARGUMENT

POINT I

The mere receipt of the claimed stock dividend in question does not under the Constitution, Statutes or Regulations constitute taxable income to the petitioner; any attempt so to impose such tax is unconstitutional and void.

For many years prior to 1936, all stock dividends were specifically made exempt from tax by statute; constitutionally, various stock dividends could not be taxed inasmuch as such stock dividends did not constitute taxable income.

Eisner v. *Macomber*, 252 U. S. 189.

It is elementary that all property received does not constitute taxable income under the Sixteenth Amendment to the Constitution of the United States, or even income.

The statutory provision, and regulation thereunder, relied upon by respondent to support the tax in question, are:

"Sec. 115 (f) Stock Dividends.

(1) General Rule. A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income

to the shareholder within the meaning of the Sixteenth Amendment to the Constitution."

"Art. 115-7 (Reg. 94) Stock Dividends.—A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall be treated as a dividend to the full extent that it constitutes income to the shareholders within the meaning of the Sixteenth Amendment to the Constitution. * * * The distinction between a stock dividend which does not, and one which does, constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution is the distinction between a stock dividend which works no change in the corporate entity, the same interest in the same corporation being represented after the distribution by more shares of precisely the same character, and a stock dividend where there either has been a change of corporate identity or a change in the nature of the shares issued as dividends whereby the proportional interest of the shareholder after the distribution is essentially different from his former interest. A stock dividend constitutes income if it gives the shareholder an interest different from that which his former stock holdings represented. A stock dividend does not constitute income if the new shares confer no different rights or interests than did the old—the new certificate plus the old representing the same proportionate interest in the net assets of the corporation as did the old." (Examples listed.)

We believe that the Regulation squarely covers the instant case and makes the claimed dividend non-taxable. In examining the Congressional purpose and intention we find the following explanation by Congressman Vinson, committee member in charge of the Bill, in connection with the Revenue Act of 1936, reported in the Congressional Record, Volume 80, Part 6, pp. 6214-15:

"Coming now to stock dividends, this is a field that has more or less been surrounded with mystery. Existing law provides that no tax shall be levied upon stock dividends. We strike that from this bill. • • •

"The kind of securities issued and the change in the proportion of ownership of a person in a corporation are the determining factors as to whether or not it is taxable income under the 16th amendment. • • •

• • •

"As we see it, a stock dividend that is not taxable is one in which the relative interest of each shareholder of a corporation is unchanged in his stock ownership. • • •

"There are, however, many instances in which dividends in stock or bonds are issued which are realized taxable incomes under the 16th amendment. The yardstick of ownership in many cases is changed—that is, the relative proportion of ownership in the corporation by a shareholder is increased or decreased.

• • • p. 6309:

"The proposed plan does not change the law and does not in the slightest degree strike at the decision of the Supreme Court in the case of *Eisner* v. *Macomber* in respect of a stock dividend where there is no change in the proportion of ownership by the shareholder."

This Court in *Eisner* v. *Macomber*, 252 U. S. 189, 207, which we accept as the law, although the respondent is in effect directly attacking the principle of that case, aptly defines the word "income" as follows:

"'Income may be defined as the gain derived from capital, from labor, or from both combined' . . . Here we have the essential matter: *Not* a gain *accruing*

to capital, not a *growth* or *increment* of value *in* the investment; but a gain, a profit, something of exchangeable value *proceeding from* the property, *severed from* the capital however invested or employed, and *coming in*, being *'derived'*, that is, *received* or *drawn by* the recipient (the taxpayer) for his *separate* use, benefit and disposal; *that* is income derived from property. Nothing else answers the description." (Italics the Court's.)

Towne v. *Eisner*, 245 U. S. 418, 426-7, defines the term "stock dividend" as follows:

"'A stock dividend really takes nothing from the property of the corporation, and adds nothing to the interests of the shareholders. Its property is not diminished and their interests are not increased .... The proportional interest of each shareholder remains the same. The only change is in the evidence which represents that interest. * * * * *Gibbons* v. *Mahon*, 136 U. S. 549, 559, 560.' * * * What has happened is that the plaintiff's old certificates have been split up in effect and have diminished in value to the extent of the value of the new."

Editorial comment is to the same effect. In Commerce Clearing House, Standard Federal Tax Service, 1941, Vol. 2, at p. 3096, the editors say:

"If there is only one class of stockholders at the time of the issuance of additional stock to all the stockholders, any dividend paid to all such stockholders in stock of the paying corporation, whether paid in common or preferred stock, would appear to be exempt under Section 115 (f), for the dividend results in no change in the proportionate interest of each stockholder in the earnings or in the assets of the corporation. * * *"

Only recently, the editors of the aforesaid Service reached the same conclusion, after reviewing all of the

decisions, including the Circuit Court decision in the instant case. (Commerce Clearing House, Standard Fed. Tax Service 1942, Vol. 1, Bulletin 9, August 5, pp. 657-662.) Notwithstanding several reported decisions relied upon by respondent which appear to justify the imposition of tax, the editors make the following significant observation: "Under the Act of 1936 and later Law such dividend would be taxable if there was other stock outstanding at the time of the dividend which did not receive a pro rata distribution." In other words where the outstanding stock did not share proportionately in the stock dividend then the dividend would be taxable; however, where all outstanding stock received a proportionate stock dividend, said dividend would not be taxable.

Sprouse v. *Commissioner*, 122 Fed. (2d) 973, (C. C. A. 9th), also pending before this Court, supports petitioner on facts similar in principle. There the stock was owned by numerous stockholders and not by a single stockholder as in the instant case. After discussing the facts and the meaning of the word "income" the Court made the following pertinent observations at page 976:

> "Generally, insofar as the stockholder is concerned, the three main differences in stocks are in the rights (1) to an interest in the assets of the corporation, the differences being in the amount of such interest and the preference it may have over other interests in the corporation; (2) to dividends, the differences being in the absoluteness of the right, and whether such right is cumulative; and (3) to manage and control the corporate venture by voting.
>
> "The Board was of the view, as appellee argues here, that if the stock distributed as a dividend, differed in its nature from that held by the stockholder, the latter derived income. In other words, differences in such characteristics as preference in interest in the assets and in dividends, and the right to vote, are proposed as the test to determine whether

the recipient of the stock dividend has derived income. We think such a test results from a misconstruction of the decisions of the Supreme Court.

"As is well known, a corporation, except in a few instances, is an entity, distinct from the stockholders. When it has earnings, the stockholders do not, by reason of that fact, have income. When it segregates those earnings, even though such earnings have accumulated in a surplus, and declares a dividend payable in money, then the stockholder receives income; or if the corporation takes from its surplus, assets and distributes them in kind to the stockholders, the latter derives income. If the corporation keeps its earnings or profits and allows them to accumulate thus building up a surplus, the surplus belongs to the corporation, not the stockholders, and while the value of the stock may increase, the stockholders do not realize on the profits until the surplus, or part thereof is distributed to them, or until they dispose of their stock.

"Where the corporation has more than one class of stock outstanding, and distributes a stock dividend to one class only, then the proportionate interests in the corporation are changed, because the class of stockholders who receive the dividend then have a greater interest in the assets of the corporation than those who did not receive the stock dividend. There being a change in the proportionate interests, the recipients of the stock dividend have derived income.

* * *

"Therefore, we believe the real test to be used in determining whether the stockholder who receives a dividend of stock in the same corporation has received income, is whether the distribution effects a change in the proportionate interest of the stockholders." (Italics ours.)

The minority opinion in the instant case in brief follows the substance of the position of the Court in the *Sprouse* case, *supra*.

Bass v. *Commissioner*, 129 Fed. (2d) 300 (C. C. A. 1st), is also similar in principle, the main difference being that the surplus was not transferred to capital. The net effect of the transaction, however, was that common stockholders received preferred stock. The Court unanimously vacated the order of the Board of Tax Appeals and remanded the case for proceedings not inconsistent with the Court's opinion.

Perhaps the most thoroughgoing of all the Board decisions on the subject is the case of *Horrmann, et al.*, 34 B. T. A. 1178. To the extent that the decision written by Board Member Arundell is pertinent to the instant case, we quote from page 1182 thereof:

> "* * * The dividend in *Eisner* v. *Macomber*, *supra*, was in common stock on stock of the same kind; here, it is in preferred stock on common stock, which was the only class outstanding. We held in *Pearl B. Brown, Executrix*, 26 B. T. A. 901; affd. 69 Fed. (2d) 602, that a dividend like the present one, namely, in preferred stock on common, where only common was outstanding, was a pure stock dividend 'constitutionally free from tax', following *Eisner* v. *Macomber*, *supra*. We said that its effect was 'a mere proliferation of existing interests'. Further:
>
> "'At the moment of change, each shareholder's proportionate rights were absolutely and relatively the same, except that each in the same ratio had preferred as well as common shares, a difference without significance here. These are the essential characteristics of a stock dividend—those which have always given point to the cases in which the question has arisen. *Gibbons* v. *Mahon*, 136 U. S. 549; *Towne* v. *Eisner*, 245 U. S. 418; *Eisner* v. *Macomber*, 252 U. S. 189; *La Belle Iron Works* v. *United States*, 256 U. S. 377; see also *Graves* v. *Graves*, 120 Atl. 420; *Kaufman* v. *Charlottesville Co.*, 23 S. E. 1003; *United States* v. *Siegel*, 52 Fed. (2d) 63.'"

After citing various other cases holding similarly because there was no severance of assets from the declarant corporations and because the stockholders' proportionate interest remained unchanged, the Board at pp. 1182-3 continued:

"We do not believe that the recent case of *Koshland* v. *Helvering*, 297 U. S. 702,* requires a different conclusion. The facts there were different in that both common and preferred stock were outstanding when a dividend on the preferred was paid in common stock. There is, as pointed out in the *Koshland* decision, a distinction between cases like the *Macomber* case and those where 'the proportional interests of the stockholder after the distribution was essentially different from his former interest.

"'* * * Where a stock dividend gives the stockholder an interest different from that which his former stock holdings represented, he receives income'. The quoted words state the theory upon which the Board and the Circuit Court of Appeals proceeded in *Tillotson Manufacturing Co.*, 27 B. T. A. 913; affd. 76 Fed. (2d) 189. In that case there were both common and preferred stock outstanding when the dividend on the preferred was paid in common stock. * * *"

To the same effect are *Commissioner* v. *Brown*, 69 Fed. (2d) 602 (C. C. A. 7th) aff'g 26 B. T. A. 901, cert. den. 293 U. S. 570, and *Clark* v. *Commissioner*, 77 Fed. (2d) 89 (C. C. A. 3rd) aff'g 28 B. T. A. 1225.

The Circuit Court, Sixth Circuit, and the Board, have also had occasion to consider the problem in the case of *Tillotson Manufacturing Co.*, 76 Fed. (2d) 189, aff'g. 27 B. T. A. 913, referred to in the *Horrmann* case herein

*Sic—298 U. S. 441.

above wherein the Board at page 916 commented as follows:

> "• • • the characteristic which gives it immunity from tax, not alone under the statute, *Towne* v. *Eisner*, 245 U. S. 418, but also under the Constitution so long as the income tax is unapportioned, *Eisner* v. *Macomber*, 252 U. S. 189, is that it represents nothing new or different from the original investment but only a further subdivision of its tokens. • • • Whether there has been a tax-free stock dividend is to be determined not by the terms used but by an analysis of the legal effect of what was done in the name of a stock dividend."

A recent Board of Tax Appeals decision tends to support petitioner.

See:

Charles F. Mitchell and Cora B. Mitchell, 45 B. T. A. 300 (1941) and

See also:

Chapman v. *United States*, 63 Ct. Cls. 106, cert. den. 275 U. S. 524;
Commissioners of Inland Revenue v. *Fisher* (1926), A. C. 395;
Commissioners of Inland Revenue v. *Blott* (1921), 2 A. C. 171.

It should be noted that Congress and the Courts have heretofore established as prerequisite to the taxability of a stock dividend that the interest be essentially different, substantially different, and we observe running through the entire Congressional, editorial and judicial discussions, the controlling criterion or determining factor, namely, the stockholder's relative proportion of owner-

ship in the corporation. Indeed in the Congressional discussions it has been called the yardstick, and the change in the law by the 1936 Act is stated not to strike at the decision in *Eisner* v. *Macomber, supra,* "in respect of a stock ownership where there is no change in the proportion of ownership by the shareholder." In the *Horrmann* case the Board held that the dividend was a pure stock dividend "constitutionally free from tax".

The Board of Tax Appeals, in the instant case, cited several decisions, to wit: *John M. Keister** 42 B. T. A. 484; *Koshland* v. *Helvering,* 298 U. S. 441; *Frank J. and Hubert Kelly Trust,* 38 B. T. A. 1014, remanded 106 Fed. (2d) 1002; *Albert E. Smith,* 39 B. T. A. 80. Those cases do not all involve the issue here presented but rather concern the basis for computing gain or loss. There is, of course, a very practical difference involved between the basis cases and dividend cases as will be pointed out later. Moreover, we respectfully submit that the *Koshland* case, fairly interpreted, does not support the imposition of tax herein. If it should be held that the Board cases are inconsistent with the principle which we urge, then we respectfully submit that those cases are wrong. There is no Circuit Court of Appeals decision supporting any of the said Board cases except the decision below; indeed the authority is to the contrary.

The court below, after reviewing the facts and the law, discusses the *Koshland* case, *supra* (R. 34), and concludes that the claimed dividend in question paid to the petitioner herein constituted taxable income.

In the *Koshland* case, however, both preferred and common stock were outstanding at the time that the common stock dividend was declared in favor of the preferred stockholders. This fact, in the words of the Circuit Court below, is stated as follows (R. 34):

---

* Reversed under name of *Sprouse* v. *Commissioner, supra.*

> "This expression of opinion would dispose of the case at bar were it not for the fact that in the *Gowran* case, as in *Koshland*, there were two classes of stock outstanding when the dividend was declared; hence the stock dividend in each of those cases changed the stockholder's proportionate interests in the net corporate assets. Here, however, there was only one class of stock outstanding and but a single stockholder, who after, as before, the dividend owned the entire beneficial interest in the net assets of the corporation."

Why this all important fact noted by the Circuit Court as the real difference between the *Koshland* case and the case at bar, was not determinative, it is difficult to understand. In the words of the Court, the following is the explanation (R. 34):

> "Nevertheless, the rearrangement of corporate capitalization so that the petitioner held preferred as well as common stock did change the character of his corporate ownership. • • •"

If there is merely a rearrangement of corporate capitalization or a recapitalization, the stock would not be subject to tax under the law, Revenue Act of 1936, Section 112 (b) (3) (g) (D), *Bass* v. *Commissioner, supra.* And respondent did not apply for certiorari in the *Bass* case. Indeed, viewed realistically, there is no stock dividend involved, but a rearrangement as the Circuit Court below said or a recapitalization. Frankly, we do not understand what the Court means by the character of the petitioner's ownership. Indeed, the true character of petitioner's ownership in the corporation was the entire ownership of the equity, and it is immaterial whether that equity is reflected by shares of preferred stock or shares of common stock or both. The Court in the *Sprouse* case,

supra, held that the true test was "whether the distribution effects a change in the proportionate interest of the stockholders." An entire interest can only be decreased, it may never be increased, and no abstruse metaphysics can change that simple fact of arithmetic.

The Court below further pointed out (R. 34) that the preferred stock had prior right to dividends and a preference on liquidation, and that these rights could be disposed of without affecting the voting control residing in the common stock (R. 34). The same contentions did not impress the Court in the *Sprouse* case. Further, such difference is one of form and not of substance in view of the fact that all of the equity rested before and still rests with the petitioner.

Moreover, it is unimportant that preferred stock may be disposed of without affecting voting control, for the sole common stockholder may likewise dispose of a portion of his common stock without affecting voting control. But *Eisner* v. *Macomber*, *supra*, held that a dividend of common on common is not taxable.

Further, if the theory of the tax were to prevent tax avoidance, which is not urged and which is not in issue, the law clearly covers such situation, for under Section 115 (g) of the Revenue Act of 1936 the cancellation, redemption or retirement of preferred stock is made taxable.

In reality, what is viewed by the Court below as taxable, is not property, but an occurrence or process of "the rearrangement of corporate capitalization" producing a change in the "character" or "quality" of the stockholder's "corporate ownership". It is the transformation in the so-called character or quality of the stockholder's interest which is being taxed, and not the actual product of the transformation. For the total product of the transformation is quantitatively neither more nor less after the change than before the change. The transforming process is obviously neither property nor an interest

in property and hence cannot constitute "income". To tax the transforming process under the guise of taxing its product is to tax something which, although it may possibly be made the subject of taxation, is nevertheless plainly not "income". To hold that such a stock-transforming process is taxable, the same as if it were "income", is to employ the judicial process for the purpose of extending taxation into a domain not yet arrived at by Congressional enactment.

Viewed from every conceivable angle and analyzed with every conceivable theory in mind, there still appears no justifiable basis for the imposition of tax liability.

To justify the tax in the instant case the Court below seized upon the statement in the *Koshland* case which sustained the imposition of tax because the shares received by the recipient gave him a "different" interest. However, the word "different" means a difference in substance and not a difference in form and was so used in the *Koshland* case. The whole principle of our Constitution preventing discrimination requires that the difference be one of substance. Certainly Congress may not discriminate, taxwise or otherwise, against red headed men or men who wear odd colored neckties. These classic school room examples are elementary principles, and yet respondent proposes just such discrimination. The learned majority below (R. 34) said: "In our opinion the case at bar is governed by the *Koshland* principle rather than by that enunciated in *Eisner* v. *Macomber*." Our answer is that the two cases present no conflicting principles and in the language of the Court in the *Sprouse* case the supposed conflict "results from a misconstruction of the decisions of the Supreme Court."

Rather do we urge as the sound and correct determination of the question presented the minority opinion of the Court below (R. 35), which requires as prerequisite to taxable income an increase in the stockholder's proportionate interest in the net assets of the corporation.

This simple criterion is we submit, the true meaning of *Koshland* v. *Helvering, supra.* Indeed, the language used fairly permits no other meaning. It was so construed by the Court in *Insull* v. *Commissioner,* 87 Fed. (2d) 648, 651 (C. C. A. 7th), rev'g. 32 B. T. A. 47, 567, 1070.

Doubt existed as to the correctness of the decision even in the minds of the majority below for it concluded its opinion as follows (R. 34):

> "It must be conceded, however, that the question is not free from doubt. * * *"

If a "different interest" meant literally what the majority stated it meant, then even in *Eisner* v. *Macomber* the stock dividend would be taxable, because the stockholder after the dividend held two pieces of paper where formerly he had only one piece of paper; he had something different, but of course, this difference was not of substance. An understanding of the nature and background of the litigation involving stock dividends makes clear what this Court meant in *Koshland* v. *Helvering* when it spoke of a different interest, if indeed, the language itself were not sufficiently clear, as we submit it was.

It is submitted that the learned majority below failed to recognize the true use of the word "different" which rightly construed may give rise to taxable income. For example, even in *Marr* v. *United States,* 268 U. S. 536, 541-542, the Court pointed out that there was a very real difference under the facts of that case as regards the interest of the stockholder after the stock dividend. The Court recognized the fundamental test as we have urged it, in the following language:

> "The case at bar is not one in which after the distribution the stockholders have the same proportional interest * * *"

Further, the Treasury Department itself interpreted the question correctly, and in support of petitioner's position. In Article 115-7 of Regulations 94, set forth on page 9 herein, it appears that the word "different" as used in the *Koshland* case means different in substance, a change in the stockholder's proportionate interest. This obvious point has already been noted herein and need not be labored.

While the Treasury Department has since eliminated practically all of Article 115-7 from the current regulations (T. D. 5020, November 15, 1940) it remained unchanged in Regulations 94 applicable to the instant case until recently, (T. D. 5110, January 19, 1942). The change shows a significant contemporaneous construction of the Statute by those charged with the enforcement thereof.

It should be noted that the sound body of law prior to the decision in the *Koshland* case held that the dividend in question was not taxable. We have already pointed out that even after the *Koshland* case, the Board decided in the *Horrmann* case that the dividend was still not taxable, distinguishing the *Koshland* case from the one there under consideration. The Board, at page 1182, says of the Koshland case:

> "The facts there were different in that both common and preferred stock were outstanding when a dividend on the preferred was paid in common stock. • • •"

Also note the recent *Mitchell* case, *supra*, decided by the Board of Tax Appeals.

Moreover, in the instant case we are dealing with but a single stockholder who had no more and no less after the stock dividend than before, who in the language of Chase, C. J. (R. 35) "owned exactly the same interest in the net value of the corporation, because he always owned it all" • • • "and therefore the real basis of decision

in the *Koshland* case is lacking and that of *Eisner* v. *Macomber* (*supra*) 252 U. S. 189, does, I think, apply. See *Sprouse* v. *Commissioner*, 122 Fed. (2d) 973." Irrespective of nice reasoning, the simple fact is that the petitioner neither in theory nor in law received taxable income or any kind of income upon the receipt of the so-called stock dividend.

As was aptly said by the Court in the recent case of *Dreyfuss* v. *Manning, Collector*, 44 Fed. Supp. 383:

> "To reason to the contrary, makes it necessary to arrive at the conclusion that the whole can be greater than the sum of its parts. Even in this advanced age, wherein thought is being tested by science and invention, no such feat as yet has been accomplished."

The *Dreyfuss* case, *supra*, is a practical and sound decision analyzing the issue here before the Court. In concluding its opinion the Court said with respect to the instant case:

> "In *Strassburger* v. *Commissioner*, 124 F. (2d) 315, the majority opinion is in direct conflict with the result arrived at here, but it should be noted that the opinion concedes that 'the question is not free from doubt.' Judge Chase, in dissenting, says 'But surely the case just mentioned (the *Koshland* case) must rest upon firmer ground than a change in the kind of shares of stock a stockholder has as the result of a dividend of stock on stock. There must also be a change in his proportionate interest in the corporation's net assets in order to have what is known as a "realization" of income.' With this dissent I find myself in full accord for the reasons above stated."

Lawyers, accountants and economists all support the fundamental principle underlying petitioner's case. Among the various articles on the subject are: Mertens, "Recent

Income Tax Trends in Stock Dividend Cases", Cornell L. Q. June, 1942; Seligman, "Are Stock Dividends Income?", 9 Am. Ec. Rev. 517; Montgomery, Federal Tax Handbook (1933, 1934) 296; Dohr, "Income Divorced from Reality", 66 Journal of Accountancy 361; Powell, "Stock Dividends, Direct Taxes and the Sixteenth Amendment", 20 Col. L. Rev. 536; Clark, "Eisner v. Macomber and Some Income Tax Problems", 29 Yale L. J. 735.

One of the ablest presentations of all phases of the subject appears in *Mertens'* article, *supra*. After analyzing the underlying legal and economic principles, the author concludes (474):

> "Where there is but one class of stock outstanding, there is no taxable dividend upon the receipt by the stockholder of a new class of stock which gives the recipient evidence of certain preferences in the distribution of earnings, even though the new preferred stock is cumulative or does not carry voting rights. • • •" (See also same article at p. 458.)

It should also be noted that the test based on what is called a "substantially different interest" evolved from exchange or reorganization cases and not dividend cases (See *Mertens*, Cornell L. Q. *supra*, at p. 468). There the stockholder ordinarily was entitled to use as his basis the cost or other basis of his original stock and the gain realized was limited to the difference between the cost and the value of the new interest acquired upon the reorganization or exchange. But with stock dividends, the gain would be treated as the fair market value of the new stock. Practically, therefore, the result would be far more burdensome in the case of stock dividends such as the instant case. The result in dollars and cents of the application of the principle to stock dividends may have prompted this Court in *Eisner* v. *Macomber*, *supra*, at

page 203 quoting from *Towne* v. *Eisner, supra,* to observe that "if the plaintiff gained any small advantage by the change, it certainly was not an advantage of $417,450, the sum upon which he was taxed * * *".

Realistically, the so-called stock dividend in question not only gave the taxpayer nothing, but actually took away something from him. For example, the corporation's surplus was larger prior to the payment of the dividend than after payment and the sole stockholder had a larger potential from which he could receive actual cash dividends. The creditors of the corporation, for whom the capital is said to constitute a trust fund, had a larger measure of protection after the amount of the dividend was debited against surplus and credited to capital. Petitioner therefore lost a potential, was further removed from realization. Assets otherwise available for distribution had become frozen into the capital structure. As has best been said by this Court in *Eisner* v. *Macomber,* p. 211:

> "A 'stock dividend' shows that the company's accumulated profits have been capitalized, instead of distributed to the stockholders or retained as surplus available for distribution in money or in kind should opportunity offer. Far from being a realization of profits of the stockholder, it tends rather to postpone such realization in that the fund represented by the new stock has been transferred from surplus to capital, and no longer is available for actual distribution."

Practically, the Government may not gain in dollars and cents by the principle sought to be established herein. For even the Treasury Department must admit that if gains are realized by a fictitious increase in a stockholder's interest in corporate assets, similarly, a loss is suffered by a stockholder's decrease in such interest. In

reality, of course, neither gain nor loss is realized. If gains are to be accelerated, likewise losses.

POINT II

Apart from the Sixteenth Amendment, the Statute and Regulation, construed in the light of legislative history do not impose any income tax on the so-called stock dividend, but if they purport to impose such tax, are void as a matter of constitutionality.

We also contend that as a matter of construction, Congress has not attempted to tax the so-called dividend in question. How shall the Courts construe the amendment if not in the light of what the framers of the Statute said? They said, as we have shown before, that the stock dividend in question received by petitioner herein is not taxable and was not intended to be taxed, even after the change in 1936. They said that they wanted to extend the tax to cover cases permitted by the decision of *Eisner* v. *Macomber*, *supra*, but that the instant case was not one of the cases which could constitutionally be affected. (See Legislative History as set forth in Congressman Vinson's remarks, pp. 8-9 herein.)

We submit, further, that even if this Court should decide that the so-called dividend received by the petitioner is constitutionally taxable, notwithstanding *Eisner* v. *Macomber*, the dividend still would not be subject to tax because Congress under the 1936 Act accepted as the controlling constitutional criterion the Supreme Court decision in *Eisner* v. *Macomber* and not the decision of the Supreme Court in any other case. Therefore, as a matter of construction stock dividends now subject to tax are such dividends which the Supreme Court had in *Eisner* v. *Macomber* permitted to be taxable. Even assuming for the sake of the argument that Congress could sweep aside

all standards and permit tax to be imposed on the basis of what may now be held constitutional, Congress has not yet done so and the Courts will not extend legislation beyond its clear legislative limits.

It is one of the elementary canons of taxation that a tax statute must be certain, clear and definite. Particularly is this true where penalties and imprisonment may be imposed for violation thereof. As heretofore pointed out the Statute may not, under the Sixteenth Amendment, impose an income tax on the stock dividend in question. However, if it should be so construed to impose a tax, then we respectfully submit that it is void as a matter of constitutionality. What has Congress said to fix tax liability herein sought to be imposed? It has said that if the dividend is not constitutionally taxable it may not be taxed. The Regulations said it affirmatively. The Sixteenth Amendment said as much, but certainly no one could soundly argue that taxes can be imposed and collected on the strength of a mere declaration that everything that is constitutionally taxable must be included in a taxpayer's return and that a failure will result in severe pains and penalties. A declaration of purpose or policy is not a tax law. There must be definiteness, certainty, clarity, a basis or formula. A statute which requires a taxpayer at his risk to be a constitutional lawyer appears hopelessly invalid.

In view of the foregoing, it is respectfully submitted that the receipt by petitioner of the preferred stock dividend did not constitute taxable income.

Conclusion

For the reasons stated and on the authority of the cases cited herein, we respectfully submit that the judgment below should be reversed.

Respectfully submitted,

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New York City.

With him on the brief,
Millard H. Ellison

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No. 1100 66

In the Supreme Court of the United States

OCTOBER TERM, 1941

EMIL H. STRASSBURGER, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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OPINIONS BELOW

The memorandum opinion of the Board of Tax Appeals (R. 12–17) is not officially reported. The opinions of the Circuit Court of Appeals (R. 32–35) are reported in 124 F. (2d) 315.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on January 7, 1942. (R. 36.) The petition for a writ of certiorari was filed on April

3, 1942. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the sole owner of all the issued voting common stock of a corporation realized taxable income upon the receipt of a stock dividend paid in seven percent non-voting cumulative preferred stock which was declared out of earnings and profits.

STATUTE AND REGULATIONS INVOLVED

The statute and regulations involved are set forth in the Appendix, *infra*, pp. 7–11.

STATEMENT

The facts, as stipulated (R. 25–27) and as found by the Board of Tax Appeals (R. 12–14), may be summarized as follows:

E. H. Strassburger, Inc., sometimes hereinafter referred to as the Corporation, was organized in or about January, 1932. On December 10, 1936, its authorized capital stock consisted of 200 shares of common stock with exclusive voting rights. (R. 12–13.) The petitioner owned all of this stock (R. 13).

On December 11, 1936, the Corporation's articles of incorporation were amended for the creation and authorization of an issue of 500 shares of $100 par value seven percent cumulative non-voting preferred stock (R. 13). On December 21, 1936,

the board of directors of the Corporation adopted a resolution of which the following is material (R. 13):

> *Now, therefore, be it resolved,* that for the purpose of representing in the capitalization of this corporation surplus assets to the extent of Five Thousand Dollars, a distribution among stockholders of the capital stock of the corporation be made of Five Thousand Dollars of preferred capital stock, and the proper officers of the corporation are hereby authorized and directed to issue an aggregate of Five Thousand Dollars, par value of preferred capital stock of this corporation, in payment of a stock dividend on the common stock of this corporation.
>
> *Further resolved,* that the directors of this corporation be authorized to distribute said Five Thousand Dollars of the preferred capital stock, pro rata, among stockholders, as and for a stock dividend on said capital stock so owned by them, such distribution to be made to stockholders of record at the close of business on December 24, 1936.

On December 24, 1936, pursuant to this resolution, 50 shares of preferred stock of the Corporation were issued to petitioner, the sole common stockholder. At the time of the distribution of the stock dividend the Corporation had earnings and profits accumulated subsequent to February 28, 1913, in excess of $5,000. Appropriate book entries were made on account of the dividend, decreasing the surplus of the Corporation by $5,000 and in-

creasing its capital stock in the same amount. (R. 13–14.)

On December 29, 1936, the 50 shares of preferred stock which petitioner had received as a dividend were transferred to his wife, Gertrude W. Strassburger. Upon her death the shares were retransferred to petitioner who is now the record holder. No dividends have been paid on the preferred stock and that stock has never been disposed of, canceled or retired. (R. 14.)

The Board of Tax Appeals held that the stock dividend represented a new and different interest in the corporation and therefore constituted taxable income (R. 14–17). The court below, with Judge Chase dissenting, affirmed the decision of the Board of Tax Appeals (R. 32–35).

ARGUMENT

We oppose the granting of the petition. It is true that the Government desires a reexamination of *Eisner* v. *Macomber*, 252 U. S. 189, but this case is an inappropriate one for that purpose, since it was correctly decided on any theory. The dividend here was not in the form of common upon common, as was the situation in *Eisner* v. *Macomber*. Here, corporate earnings were set aside and cumulative non-voting preferred stock was issued against those earnings to petitioner, who, prior thereto, owned only common stock. Those corporate earnings were thus made available to petitioner in the form of a new and different class of stock, and were

therefore taxable to him in accord with the theory underlying *Helvering* v. *Gowran*, 302 U. S. 238, and *Koshland* v. *Helvering*, 298 U. S. 441, irrespective of the correctness of *Eisner* v. *Macomber*.

The Government did seek a reexamination of *Eisner* v. *Macomber* in *Helvering* v. *Sprouse*, No. 894, present Term, certiorari denied, March 2, 1942, rehearing denied, March 30, 1942. The *Sprouse* case involved a dividend of non-voting common upon common, and it may be that the issue was not squarely raised in that case for that reason. The instant case presents a situation that is even more remote from *Eisner* v. *Macomber*, since the dividend stock here was of an entirely different class from the parent stock. Moreover, even upon the narrower ground, the Government in the *Sprouse* case alleged a conflict with the decision in the instant case (Pet. 10–11), and the denial of certiorari in the *Sprouse* case would seem to remove any basis for certiorari here upon that narrower ground.

Petitioner alleges further conflicts with two other decisions, *Clark* v. *Commissioner*, 77 F. (2d) 89 (C. C. A. 3d), and *Commissioner* v. *Brown*, 69 F. (2d) 602 (C. C. A. 7th). Neither of those cases presented the issue involved herein. The *Clark* case involved an exchange of stock for other stock, rather than a stock dividend. The *Brown* case turned upon whether the redemption of certain stock was the equivalent of a distribution of a taxable dividend under Section 201 (g) of the Revenue Act of 1926. In any event, the Revenue Acts then

in force, unlike the Revenue Act of 1936, exempted all stock dividends from tax.

CONCLUSION

The petition should be denied.

Respectfully submitted.

CHARLES FAHY,
Solicitor General.
SAMUEL O. CLARK, JR.,
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SEWALL KEY,
MORTON K. ROTHSCHILD,
Special Assistants to the Attorney General.

APRIL 1942.

APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 22. GROSS INCOME.

(a) General Definition.—"Gross income" includes gains, profits, and income derived from * * * dividends, * * *.

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this title (except in section 203 (a) (3) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

* * * * *

(f) *Stock Dividends.*—

(1) *General Rule.*—A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution.

(2) *Election of Shareholders as to Medium of Payment.*—Whenever a distribution by a corporation is, at the election of

any of the shareholders (whether exercised before or after the declaration thereof), payable either (A) in its stock or in rights to acquire its stock, of a class which if distributed without election would be exempt from tax under paragraph (1), or (B) in money or any other property (including its stock or in rights to acquire its stock, of a class which if distributed without election would not be exempt from tax under paragraph (1)), then the distribution shall constitute a taxable dividend in the hands of all shareholders, regardless of the medium in which paid.

* * * * *

Treasury Regulations 94, relating to the Revenue Act of 1936:

ART. 115-7. *Stock dividends.*—A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall be treated as a dividend to the full extent that it constitutes income to the shareholders within the meaning of the sixteenth amendment to the Constitution. The Supreme Court has pointed out some of the characteristics distinguishing a stock dividend which constitutes income from one which does not constitute income within the meaning of the Constitution.[1] The distinc-

[1] See *Eisner* v. *Macomber* (252 U. S. 189, T. D. 3010, C. B. 3, 25); and *Koshland* v. *Helvering* (56 Sup. Ct., 767, Ct. D. 1124, C. B. XV-1, 219). Compare *United States* v. *Phellis* (257 U. S., 156, T. D. 3270, C. B. 5, 37); *Rockefeller* v. *United States* (257 U. S., 176, T. D. 3271, C. B. 5, 34); *Cullinan* v. *Walker* (262 U. S., 134, T. D. 3508, C. B. II-2, 55); *Weiss* v. *Stearn* (265 U. S., 242, T. D. 3609, C. B. III-2, 51); and *Marr* v. *United States* (268 U. S., 536, T. D. 3755, C. B. IV-2, 116).

tion between a stock dividend which does not, and one which does, constitute income to the shareholder within the meaning of the sixteenth amendment to the Constitution is the distinction between a stock dividend which works no change in the corporate entity, the same interest in the same corporation being represented after the distribution by more shares of precisely the same character, and a stock dividend where there either has been a change of corporate identity or a change in the nature of the shares issued as dividends whereby the proportional interest of the shareholder after the distribution is essentially different from his former interest. A stock dividend constitutes income if it gives the shareholder an interest different from that which his former stock holdings represented. A stock dividend does not constitute income if the new shares confer no different rights or interests than did the old—the new certificates plus the old representing the same proportionate interest in the net assets of the corporation as did the old.

Example (1): The X Corporation had an authorized capital stock of $300,000 of common stock, par value $10 a share, and $100,000 of 7 percent cumulative preferred stock, par value $100 a share, which is preferred as to dividends, has no voting rights, and may be redeemed at any time at $105 per share. The articles of incorporation provide that the annual dividend on the preferred stock may be paid in cash or, at the option of the corporation, in one share of common stock for each share of preferred. On July 1, 1936, the X Corporation had outstanding $200,000 of common stock and $100,000 of preferred stock, earnings and profits of $60,000 accumulated since Febru-

ary 28, 1913, and earnings and profits of the taxable year amounting to $15,000. On July 1, 1936, it distributed 1,000 shares of its common stock of an aggregate par value (and fair market value) of $10,000 to the holders of its preferred stock in payment of the annual dividend on such stock. The stock so distributed constitutes a taxable stock dividend to the holders of the preferred stock.

Example (2): On July 1, 1936, the Y Corporation had an authorized capital stock consisting of 1,000 shares of common stock, par value $100 a share, of which 500 shares were outstanding. It had earnings and profits of $40,000 accumulated since February 28, 1913, and $5,000 of earnings and profits of the taxable year. On July 1, 1936, the Y Corporation issued and divided among its shareholders 250 additional shares of its common stock of a total par value of $25,000 and transferred an equivalent amount from surplus account to capital stock account. The stock so distributed does not constitute a taxable stock dividend to the shareholders.

Example (3): The Z Corporation had an authorized capital stock of 30,000 shares of common, without par value, and 10,000 shares of 7 percent cumulative preferred stock, par $100, which is preferred as to dividends, has voting rights and may be redeemed on the 1st of January or July of any year by the payment of $105 per share and accrued dividends. On July 1, 1936, the company's issued and outstanding stock amounted to 20,000 shares of common and 6,000 shares of preferred, and it had $250,000 earnings and profits accumulated since February 28, 1913, and $90,000 earnings and profits of the taxable year. On July 1, 1936, it paid a dividend on its common stock in preferred stock at the rate of 1/10 share of

preferred on each share of common outstanding. The preferred stock so distributed constitutes a taxable stock dividend to the holders of common stock.

T. D. 5110, 1942–4 Int. Rev. Bull. 7:

Article 115–7 of Regulations 94 [section 3.115–7, Title 26, Code of Federal Regulations] and article 115–7 of Regulations 101 [section 9.115–7, Title 26, Code of Federal Regulations, 1939 Sup.] are each amended by striking out all of the matter appearing after the first sentence thereof.

(This Treasury decision is issued under the authority contained in section 62 of the Revenue Act of 1936 (49 Stat., 1673, 26 U. S. C., Sup. 62) and section 62 of the Revenue Act of 1938 (52 Stat., 480, 26 U. S. C., Sup. 62).)

GUY T. HELVERING,
Commissioner of Internal Revenue.

Approved January 19, 1942.

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No. 66

In the Supreme Court of the United States

OCTOBER TERM, 1942

EMIL H. STRASSBURGER, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT

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In the Supreme Court of the United States

OCTOBER TERM, 1942

No. 66

EMIL H. STRASSBURGER, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The memorandum opinion of the Board of Tax Appeals (R. 12–17) is not officially reported. The opinions of the Circuit Court of Appeals (R. 32–35) are reported in 124 F. (2d) 315.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on January 7, 1942 (R. 36). The petition for a writ of certiorari was filed on April 3, 1942, and was granted on May 11, 1942. The jurisdiction of this Court rests upon Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the owner of all the issued voting common stock of a corporation realized taxable income upon the receipt of a stock dividend paid in seven percent nonvoting cumulative preferred stock, which was declared out of the corporation's earnings and profits.

CONSTITUTIONAL PROVISIONS, STATUTE AND REGULATIONS INVOLVED

The constitutional provisions, statute and regulations involved are set forth in the Appendix, *infra*, pp. 48–53.

STATEMENT

The facts, as stipulated (R. 25–27) and as found by the Board of Tax Appeals (R. 12–14), may be summarized as follows:

E. H. Strassburger, Inc., hereinafter referred to as the corporation, was organized in or about January of 1932. On December 10, 1936, its authorized capital stock consisted of 200 shares of common stock with exclusive voting rights. The petitioner owned all this stock. (R. 12–13.)

On December 11, 1936, the corporation's articles of incorporation were amended to provide for the issuance of 500 shares of $100 par value seven percent cumulative nonvoting preferred stock (R. 13). On December 21, 1936, the corporation's board of directors adopted a resolution of which the following is material (R. 13):

> NOW, THEREFORE, BE IT RESOLVED, that for the purpose of representing in the capitali-

zation of this corporation surplus assets to the extent of Five Thousand Dollars, a distribution among stockholders of the capital stock of the corporation be made of Five Thousand Dollars of preferred capital stock, and the proper officers of the corporation are hereby authorized and directed to issue an aggregate of Five Thousand Dollars, par value of preferred capital stock of this corporation, in payment of a stock dividend on the common stock of this corporation.

FURTHER RESOLVED, that the directors of this corporation be authorized to distribute said Five Thousand Dollars of the preferred capital stock, pro rata, among stockholders, as and for a stock dividend on said capital stock so owned by them, such distribution to be made to stockholders of record at the close of business on December 24, 1936.

On December 24, 1936, 50 shares of the preferred stock were issued to the taxpayer, the sole common stockholder, in pursuance of the resolution. At the time of the distribution of this stock dividend, the corporation had earnings and profits accumulated subsequent to February 28, 1913, in excess of $5,000. Appropriate book entries were made on account of the dividend decreasing the surplus of the corporation by $5,000 and increasing its capital stock in the same amount. (R. 13–14.)

On December 29, 1936, the 50 shares of preferred stock, which the taxpayer had thus re-

ceived as a dividend, were transferred to his wife, Gertrude W. Strassburger. Upon her death the shares were retransferred to the taxpayer, who is now the record holder. No dividends have been paid on the preferred stock, and that stock has never been disposed of, canceled, or retired. (R. 14.)

The Board of Tax Appeals held that the stock dividend constituted taxable income (R. 14–17). The court below affirmed, Judge Chase dissenting (R. 32–35).

SUMMARY OF ARGUMENT

In Sections 22 (a) and 115 of the Revenue Act of 1936 Congress has exercised its power to tax stock dividends as income to the full extent permitted by the Constitution. The only question, therefore, is as to the extent of its authority under the Constitution.

I

A. The basic power to tax rests upon Article I, Section 8, Clause 1, of the Constitution. That power "is exhaustive and embraces every conceivable power of taxation." *Brushaber* v. *Union Pac. R. R.*, 240 U. S. 1, 12. Apart from the specific prohibition against taxing exports, the taxing power is subject only to two restrictions: (1) duties, imposts, and excises must be uniform throughout the United States; and (2) "direct" taxes must be apportioned among the states according to population.

Thus, stock dividends are obviously subject to tax under the sweeping authority of Article I, Section 8, Clause 1, the only question being whether the tax is "direct" and is therefore subject to the apportionment requirement.

The practice of Congress and the decisions of this Court during the first century under the Constitution show that the unworkable apportionment requirement was intended to have but very limited application. Indeed, this Court had held that only capitation taxes and taxes upon real estate were embraced within the term "direct taxes." *Springer* v. *United States,* 102 U. S. 586, 602. However, a sharply divided Court in *Pollock* v. *Farmers' Loan & Trust Co.,* 157 U. S. 429, 158 U. S. 601, thereafter held that the 1894 income-tax statute was unconstitutional in part, at least, because the tax upon income from real estate was not apportioned. The Sixteenth Amendment was then adopted and in effect constituted a reversal of that decision.

It seems abundantly clear that but for the *Pollock* decision, stock dividends based upon corporate earnings are constitutionally taxable without apportionment under Article I, and that whatever doubt the *Pollock* case had cast upon the validity of such a tax has been removed by the Sixteenth Amendment.

B. 1. In providing that a tax upon "income" need not be apportioned, the Sixteenth Amendment employed that term in its broadest sense

and was designed to put at rest all such questions as are here presented. Even before the *Pollock* case, stock dividends were regarded *as income* under the Civil War income tax laws (*Bailey* v. *Railroad Co.*, 22 Wall. 604, 635), and the reversal of the *Pollock* decision through the Sixteenth Amendment was certainly not intended to leave Congress with less power than it was thought to possess before that decision. The contrary ruling in *Eisner* v. *Macomber*, 252 U. S. 189, is erroneous and should be re-examined.

2. There is an even more fundamental reason which justifies the tax upon a stock dividend to the extent that it is supported by corporate earnings. Congress has the authority to treat a corporation as an association of individuals who have united for the purpose of conducting a business enterprise, and it may require each of them to account periodically with respect to his pro rata share of the corporate profits. This Court has already sustained such a tax against members of a partnership with respect to their distributive share of the partnership earnings notwithstanding that those earnings in fact could not have been distributed during the year in question. *Heiner* v. *Mellon*, 304 U. S. 271, 280–281. And under the Civil War income tax laws, corporate earnings were actually taxed directly to the stockholders, whether distributed or not. *Collector* v. *Hubbard*, 12 Wall. 1, 18. If the stockholder's pro rata share of the cor-

porate earnings were treated as income to him under those early income tax laws, surely the sweeping terms of the Sixteenth Amendment should be given no narrower interpretation. Accordingly, if Congress may tax the stockholders upon their share of the corporate earnings, it plainly has the lesser power of taxing such earnings to the stockholders when stock dividends have been declared against them. Of course, the mere declaration of a stock dividend is not an income-producing transaction; but it does mark the occasion when the shareholder may be asked to account for the profit that has been accruing up to that point of time, and the stock dividend embodying that profit may be treated as "income."

3. The decision in *Eisner* v. *Macomber* not only misconceived the broad scope of the taxing power under Article I and failed to recognize the known purpose of the Sixteenth Amendment, but, in addition, introduced certain erroneous concepts and refinements as to the "realization" of "income" which have been repudiated by other decisions of this Court.

Thus, it held that a stock dividend could not constitute income because there was no "outgo" from the corporation. However, *Koshland* v. *Helvering*, 298 U. S. 441, and other decisions of this Court, are squarely to the contrary.

Again, it was held in *Eisner* v. *Macomber* that profit must be "severed" from capital before it

can be treated as "income." Numerous subsequent decisions are plainly inconsistent with that ruling. See particularly, *Helvering* v. *Bruun*, 309 U. S. 461.

Finally, the entire decision appeared to be pervaded by the fundamental misconception that there could be no income to the stockholder because he was no wealthier immediately after the stock dividend than he had been immediately before. But the same is true whenever a capital asset is sold or exchanged at a profit. Generally, the taxpayer is no wealthier immediately after such a sale or exchange than he had been the moment before: the sale or exchange simply marks the moment of time when the profit which has theretofore been accruing gradually may be charged to him. Similarly, the declaration of the stock dividend simply constitutes the occasion when corporate earnings, which have been accumulating over a period of time, may be charged to those who are the beneficial owners of those earnings. Fundamentally, the problem of "realization" is merely one of finding an appropriate time for the measurement of a taxpayer's increase in wealth in order to compute, in accordance with the principle of ability to pay, the amount of his contribution toward the maintenance of the society in which he lives. That problem is essentially, and by its very nature, legislative in character and we urge that the Sixteenth Amendment left the reso-

lution of such questions in the legislative branch of the Government. Congress should be left free to designate any convenient event as appropriate for the measurement of increases in wealth. The concept of "realization" should impose no greater restraint than this.

C. If, as we contend, *Eisner* v. *Macomber* was erroneously decided, it should be expressly overruled. The decision has not only been the source of great confusion, but it has long cast a restrictive influence upon the Treasury and Congress in developing a sound system for the taxation of corporate earnings in the hands of those who are the beneficial owners of those profits. The public interest requires that fiscal policies be allowed to develop free from the shadow of erroneous constitutional limitations.

II

Although we think that *Eisner* v. *Macomber* should be expressly overruled, the decision below may be affirmed upon the narrow ground that the dividend stock received was preferred stock and embodied new rights that were different from the common stock upon which it had been declared.

ARGUMENT

Introductory; the statutory provisions involved.—Since the preferred stock dividend was paid out of the corporation's earnings and profits accumulated after February 28, 1913, it was specif-

ically covered by Sections 22 and 115 of the Revenue Act of 1936, c. 690, 49 Stat. 1648 (Appendix, *infra*, p. 49). Section 22 (a) defines gross income as including "gains, profits, and income derived from * * * dividends * * *," and Section 22 (d) declares that corporate distributions "shall be taxable to the shareholders as provided in section 115." Section 115 (a) defines a dividend to include "any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, * * *." And Section 115 (f) (1) thereupon in effect provides that a stock dividend shall be treated as a dividend to the extent that it constitutes income to the shareholder within the meaning of the Sixteenth Amendment. The history of these provisions is illuminating.

As a result of the broad language of the majority opinion in *Eisner* v. *Macomber*, 252 U. S. 189, it was erroneously assumed both by Congress[1] and

[1] After that decision, Congress provided in sweeping language in all of the revenue acts from 1921 through 1934 that "a stock dividend shall not be subject to tax." Revenue Act of 1921, c. 136, 42 Stat. 227, Section 201 (d); Revenue Act of 1924, c. 234, 43 Stat. 253, Section 201 (f); Revenue Act of 1926, c. 27, 44 Stat. 9, Section 201 (f); Revenue Act of 1928, c. 852, 45 Stat. 791, Section 115 (f); Revenue Act of 1932, c. 209, 47 Stat. 169, Section 115 (f); Revenue Act of 1934, c. 277, 48 Stat. 680, Section 115 (f). These provisions were stated in the committee reports to have been "required by the decision of the Supreme Court in *Eisner* v. *Macomber*." See H. Rep. No. 350, 67th Cong., 1st Sess., p. 8 (1939–1 Cum. Bull.

by the Treasury[2] that all kinds of stock dividends fell within the condemnation of that decision, and accordingly all stock dividends were thereafter specifically exempted by statute. It was subsequently shown, however, in *Koshland* v. *Helvering*, 298 U. S. 441, 444–447, that such an assumption was unwarranted, since there were at least some types of stock dividends that were not governed by *Eisner* v. *Macomber*. And in order to avoid such confusion in the future, the Revenue Act of 1936, enacted shortly after the *Koshland* decision, provided that taxability should be coextensive with constitutional power. Thus, Section 115 (f) (1) of the 1936 Act declares:

> (f) STOCK DIVIDENDS.—
>
> (1) *General Rule.*—A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution.

(Part 2) 168, 175); S. Rep. No. 275, 67th Cong., 1st Sess., p. 9 (1939–1 Cum. Bull. (Part 2) 181, 187).

[2] See T. D. 3206, 5 Cum. Bull. 42, amending Article 1547 of Treasury Regulations 45 (1920 edition); Article 1548, Treasury Regulations 62 (promulgated under the Revenue Act of 1921), 65 (promulgated under the Revenue Act of 1924), and 69 (promulgated under the Revenue Act of 1926); Article 628, Treasury Regulations 74 (promulgated under the Revenue Act of 1928) and 77 (promulgated under the Revenue Act of 1932); Article 115–8 of Treasury Regulations 86 (promulgated under the Revenue Act of 1934).

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Although the rule is stated negatively in this provision, the legislative history makes its meaning clear beyond question. As originally reported to and passed by the House, Section 115 (f) (1) of the 1936 revenue bill read as follows (H. R. 12395, 74th Cong., 2d Sess.):

> (f) STOCK DIVIDENDS.—
>
> (1) *General Rule.*—A distribution made by a corporation to its shareholders in stock of the corporation or in rights to acquire stock of the corporation shall be treated as a taxable dividend to the extent that such distribution constitutes income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution and represents a distribution of earnings or profits accumulated after February 28, 1913.

However, as a result of certain changes in Section 115 (a) which were made in the Senate, it was thought necessary to reword Section 115 (f) (1) so that it would conform to the changes in 115 (a). Accordingly, Section 115 (f) was rephrased, but the report of the Senate Finance Committee made it plain that there was no intention to change its meaning or effect (S. Rep. No. 2156, 74th Cong., 2d Sess., pp. 18–19):

> SECTION 115 (F). STOCK DIVIDENDS.
>
> This subsection of the House bill, under which stock dividends are made taxable to the full extent permitted by the Constitution, is retained by your committee, except for changes made necessary by virtue of the

reported amendment of section 115 (a) and in the interest of greater clarity.

Moreover, the Treasury Regulations issued under the 1936 and subsequent revenue acts all construe Section 115 (f) (1) as follows:[3]

> A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall be treated as a dividend to the full extent that it constitutes income to the shareholders within the mean-

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[3] See Article 115–7 of Treasury Regulations 94 (Appendix, *infra*) and 101 (promulgated under the Revenue Act of 1938), and Section 19.115–7 of Treasury Regulations 103 (promulgated under the Internal Revenue Code).

As originally promulgated, the regulations went further, and undertook to discuss the decisions of this Court in an attempt to indicate how far the tax could be imposed under the Constitution. However, that discussion was subsequently eliminated by T. D. 5020 and T. D. 5110 (Appendix, *infra*, p. 53), thus leaving only the sentence quoted above. Since that discussion was merely an attempt to state the result of the decisions of this Court rather than to interpret the statute, it, of course, could have no binding effect. Cf. *Helvering* v. *Hallock*, 309 U. S. 106, 121, footnote 8. Similarly, the statements made in Congress (80 Cong. Rec., part 6, pp. 6214–15, 6309–10) that the new provisions were not an "attack upon" *Eisner* v. *Macomber*, simply indicate that Congress was legislating to the full extent of its power, and that it was leaving to the courts the question of how far its power extended. Any doubt on this question is removed by the reports of both the House and Senate committees which unambiguously stated that stock dividends were to be taxed "to the full extent permitted by the Constitution." See S. Rep. No. 2156, 74th Cong., 2d Sess., p. 18; H. Rep. No. 2475, 74th Cong., 2d Sess., p. 10. A similar situation was present in *United States* v. *Wrightwood Dairy Co.*, 315 U. S.

ing of the sixteenth amendment to the Constitution. * * *

Therefore, if Congress has the power under the Constitution to tax the stock dividend in question, it has exercised that power here. Cf. *Helvering* v. *Stockholms &c. Bank*, 293 U. S. 84, 89; *Douglas* v. *Willcuts*, 296 U. S. 1, 9; *United States* v. *Safety Car Heating Co.*, 297 U. S. 88, 93; *Helvering* v. *Midland Ins. Co.*, 300 U. S. 216, 223; *Helvering* v. *Clifford*, 309 U. S. 331, 334.

I

A STOCK DIVIDEND PAYABLE OUT OF CORPORATE EARNINGS OR PROFITS IS CONSTITUTIONALLY TAXABLE WITHOUT APPORTIONMENT. THE CONTRARY RULING IN *EISNER* V. *MACOMBER* SHOULD BE REEXAMINED

A. *The scope of the taxing power under the Constitution*

The lack of any effective power to tax was regarded as one of the principal weaknesses of the national government under the Articles of Confederation, and indeed "was one of the causes that led to the adoption of the present Constitution." *Springer* v. *United States*, 102 U. S. 586, 595–596. Cf. *Hylton* v. *United States*, 3 Dall. 171, 178; The

110, 121–125, where the Court held that Congress had evidenced an intention to exercise its power to the full extent permitted by the commerce clause under the Constitution, and where the Court rejected statements of some members of the Senate to the contrary.

Federalist, Nos. 21, 30.[4] In response to the then existing critical situation the Constitution conferred upon Congress an all-embracing power to tax in Article I, Section 8, Clause 1, which provides:

> The Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States; * * *

The authority so conferred "is exhaustive and embraces every conceivable power of taxation." *Brushaber* v. *Union Pac. R. R.*, 240 U. S. 1, 12. Apart from the specific prohibition against levying a tax or duty upon exports (Art. I, Sec. 9, cl. 5), the foregoing basic power to tax is plenary, and the mode of its exercise is limited only by two restrictions: (1) duties, imposts, and excises must be uniform throughout the United States (Art. I, Sec. 8, cl. 1); and (2) direct taxes must be apportioned among the states according to population (Art. I, Sec. 2, cl. 3, and Art. I, Sec. 9, cl. 4)

Thus, it is plain, and indeed it has never been disputed, that Congress may tax stock dividends under the sweeping authority of Article I, Section

[4] In the Federalist, No. 30, attributed to Alexander Hamilton, it was stated that the weakness of the system of obtaining revenue through requisitions under the Articles of Confederation "has chiefly contributed to reduce us to a situation, which affords ample cause both of mortification to ourselves, and of triumph to our enemies."

8, clause 1. The only objection to the tax is that it is a "direct" tax, that it must therefore be apportioned among the states according to population, and that the Sixteenth Amendment has failed to relieve the tax of the apportionment requirement.

The apportionment requirement was intended to have only a very limited application; for, although the Constitution contains no definition[5] of "direct taxes," it soon became clear that only capitation taxes and taxes on real estate were regarded as direct taxes. As early as 1794 Congress imposed a tax upon carriages (1 Stat. 373) which was challenged because it was not apportioned, but its validity was sustained by this Court in *Hylton* v. *United States*, 3 Dall. 171. Of the four justices who participated, two (Wilson and Paterson) had been members of the Constitutional convention, and Alexander Hamilton, then in private life, appeared together with the Attorney General in support of the tax. Although the Court found it unnecessary to define a direct tax, it was indicated that the Constitution contemplated only two direct taxes, a capitation or poll tax and a tax upon land. See 3 Dall. at 175.[6]

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[5] Nor are the debates in the Constitutional convention illuminating upon this question. Madison's journal indicates that although Rufus King asked what was "the precise meaning of *direct* taxation", no one answered. See Documents, Formation of the United States (Govt. Printing Office 1927), p. 580.

[6] The concept of apportioned taxes was undoubtedly derived from the crude practice which existed under the Ar-

For nearly a century after the *Hylton* case Congress imposed and this Court sustained a wide variety of unapportioned taxes. That period was rich in history that served to confirm the full scope of the taxing power. Of particular note was *Springer* v. *United States*, 102 U. S. 586, 602, in which the Court expressly ruled that capitation and real estate taxes were the only taxes covered by the constitutional requirement of apportionment, and in which the Court upheld the income taxes im-

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ticles of Confederation. Under the Confederacy, the Congress would from time to time estimate the needs of the national government and would make requisitions upon the individual states according to some method of apportionment. See The Federalist, No. 30. But it was plain that an apportioned tax could have only a very limited sphere of operation under the Constitution. For example, as observed by Mr. Justice Chase in the *Hylton* case, if the carriage tax were apportioned, there might be two states equal in population, one of which might have ten times as many carriages as the other. The consequence would be that the owner of a carriage in one of those states would be subject to a burden ten times as great as a similar owner in the other state. See 3 Dall. at 174. And in *Pacific Insurance Co.* v. *Soule*, 7 Wall. 433, 446, involving a tax upon receipts of insurance companies, it was pointed out that if the tax were apportioned, it would be light where such corporations were numerous and rich, and that in those states where they were few and poor the tax "would fall upon them with such weight as to involve annihilation." The Court added "It cannot be supposed that the framers of the Constitution intended that any tax should be apportioned, the collection of which on that principle would be attended with such results. The consequences are fatal to the proposition." *Ibid.*

posed during the Civil War.[7] Moreover, the practice of Congress, particularly during the early years, under the Constitution, confirms this view. For, the only apportioned taxes that it attempted to levy were upon real estate.[8] And such commentators as Story, Kent, and Miller, who enjoy a particularly high place in American jurisprudence, were unanimous in indicating that direct taxes were to be limited to capitation and real estate taxes.[9] Surely, here was a situation in which "a page of history is worth a volume of logic" (*New York Trust Co.* v. *Eisner*, 256 U. S. 345, 349).

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[7] Similarly, the Court had sustained a tax upon receipts of insurance companies in *Pacific Insurance Co.* v. *Soule*, 7 Wall. 433. The well-known bank note tax likewise survived the contention that it was invalid as an unapportioned direct tax. *Veazie Bank* v. *Fenno*, 8 Wall. 533. In *Scholey* v. *Rew*, 23 Wall. 331, the Court sustained an unapportioned tax upon successions. See also *Railroad Co.* v. *Collector*, 100 U. S. 595; *Knowlton* v. *Moore*, 178 U. S. 41; *New York Trust Co.* v. *Eisner*, 256 U. S. 345; *Bromley* v. *McCaughn*, 280 U. S. 124; *Nicol* v. *Ames*, 173 U. S. 509; *Treat* v. *White*, 181 U. S. 264; *Flint* v. *Stone Tracy Co.*, 220 U. S. 107; *Steward Machine Co.* v. *Davis*, 301 U. S. 548, 578-583.

[8] See 1 Stat. 53; 3 Stat. 53; 3 Stat. 164; 3 Stat. 255; 12 Stat. 294. Several of these statutes also included an apportioned tax upon slaves, but at that time slaves were regarded in some of the states as real estate. See 1 Hurd, Law of Freedom and Bondage, p. 239.

[9] 1 Story, Constitution of United States (4th ed., 1873), § 955; 1 Kent, Commentaries *256; Miller, Constitution (1891), p. 237. Cf. Rawle, Constitution (2d ed., 1829), p. 80; Pomeroy, Constitutional Law (3d ed., 1888), § 277; Sergeant, Constitutional Law (1830), p. 305; 1 Hare, American Constitutional Law (1889), p. 250.

Notwithstanding the historical background outlined above, it was held in *Pollock* v. *Farmers' Loan & Trust Co.*, 157 U. S. 429, 158 U. S. 601, that a tax upon income from property is equivalent to a tax upon the property itself, that it is therefore a direct tax and is invalid unless apportioned. But it is to be observed that even the *Pollock* decision [10] did not hold that an income tax generally was a direct tax, and indeed the majority opinion intimated that a tax on professional

[10] Although this Court undertook to distinguish the *Pollock* case in *N. Y. ex rel. Cohn* v. *Graves*, 300 U. S. 308, it in effect destroyed the basis upon which the *Pollock* case rested. The *Graves* case involved a New York tax upon rents derived from New Jersey real estate. In holding that New York could tax those rents even though it was without power to tax the property, the Court said (p. 314):

> Neither analysis of the two types of taxes, nor consideration of the bases upon which the power to impose, them rests, supports the contention that a tax on income is a tax on the land which produces it. The incidence of a tax on income differs from that of a tax on property. Neither tax is dependent upon the possession by the taxpayer of the subject of the other. His income may be taxed, although he owns no property, and his property may be taxed, although it produces no income. The two taxes are measured by different standards, the one by the amount of income received over a period of time, the other by the value of the property at a particular date. Income is taxed but once; the same property may be taxed recurrently. The tax on each is predicated upon different governmental benefits; the protection offered to the property in one state does not extend

earnings would not have to be apportioned. 157 U. S. at 579. The statute was invalidated as a whole, however, only because it was thought that Congress intended its various provisions to be inseparable from each other. 158 U. S. at 635–637. Accordingly, even after the *Pollock* case there was considerable room for the imposition of unapportioned income taxes under the Constitution as it then stood. Cf. *Flint* v. *Stone Tracy Co.*, 220 U. S. 107. Nevertheless, it was desired to untie the hands of Congress completely, and the Sixteenth Amendment was adopted. Under the Amendment, the power of Congress was not to be restricted by reason of the source of the income. It specifically provided:

> The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.

The Amendment was not designed as a limitation upon the taxing power. Rather, it was intended to *expand* the taxing authority, giving full scope to Congressional power under Article I, unencumbered by the unworkable requirement of appor-

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to the receipt and enjoyment of income from it in another.

See also *Knowlton* v. *Moore*, 178 U. S. 41, 82; *Brushaber* v. *Union Pac. R. R.*, 240 U. S. 1, 16; *Hale* v. *State Board*, 302 U. S. 95, 107; *Graves* v. *N. Y. ex rel. O'Keefe*, 306 U. S. 466; *O'Malley* v. *Woodrough*, 307 U. S. 277.

tionment which the majority of the Court thought existed with respect to certain types of income.

No one has ever doubted that stock dividends could be taxed under the plenary power granted by Article I, the only question being whether the tax must be apportioned. We submit that even under the *Pollock* decision, there is no foundation for the conclusion that a tax upon stock dividends is a direct tax,[11] and that in any event whatever basis there may have been for the apportionment requirement has been removed by the Sixteenth Amendment. Even after the Sixteenth Amendment the basic power to tax continues to rest upon Article I; that power is all embracing; and the Sixteenth Amendment was intended to sweep away any possible qualifications upon that power that might be read into it as a result of the

[11] Fundamentally, wholly apart from the Sixteenth Amendment, the issuance or receipt of a stock dividend is as proper a subject for an unapportioned tax as an agreement to sell a share of stock (*Thomas* v. *United States*, 192 U. S. 363) or the issuance of bank notes (*Veazie Bank* v. *Fenno*, 8 Wall. 533). Nor can there be any valid objection under the due process clause or otherwise that the stock dividend is blended together with other income of the recipient for the purpose of determining the effective rate of surtax. The taxpayer's ability to pay may be taken into account in fixing the amount of the burden. Cf. *Maxwell* v. *Bugbee*, 250 U. S. 525; *Atl. & Pac. Tea Co.* v. *Grosjean*, 301 U. S. 412. The fact that the tax is described as a tax upon "income" is constitutionally irrelevant, if the legislature in fact has the power to impose it. Cf. *Wisconsin* v. *J. C. Penney Co.*, 311 U. S. 435, 443.

Pollock case.[12] Taking Article I and the Sixteenth Amendment together, we submit that there is the most ample authority for an unapportioned tax upon stock dividends.

B. *Stock dividends based upon corporate earnings or profits are taxable to the stockholders under Article I and the Sixteenth Amendment without apportionment*

1. It was recognized by this Court some twenty years before the *Pollock* decision that stock dividends were properly taxable under the Civil War income tax laws. *Bailey v. Railroad Co.*, 22 Wall. 604, 635. Indeed, the pivotal question in the *Bailey* case was whether the distribution of certain "certificates" was the equivalent of a stock dividend, it being conceded that if it were, the distribution would be taxable. Stock dividends were thus historically treated *as income*, and whatever adverse effect the *Pollock* case might otherwise have had upon the taxability of stock dividends without apportionment, must be regarded as having been removed by the Sixteenth Amendment.

It should be recalled that the Sixteenth Amendment was in effect a reversal of the *Pollock* decision, and, like every other constitutional provision, it should be broadly interpreted so

[12] Cf. *Stanton* v. *Baltic Mining Co.*, 240 U. S. 103, 112; *Peck & Co.* v. *Lowe*, 247 U. S. 165.

as to give Congress whatever power can reasonably be read into its terms. Cf. *McCulloch* v. *Maryland*, 4 Wheat. 316, 407; *Martin* v. *Hunter's Lessee*, 1 Wheat. 304, 326. The approach of the Supreme Judicial Court of Massachusetts with respect to a similar amendment to the state constitution is peculiarly relevant here. An amendment had been adopted authorizing the state to tax "income," and the charge was made that a stock dividend could not be taxed under that amendment. In rejecting that contention the court pointedly declared (*Tax Commissioner* v. *Putnam*, 227 Mass. 522, 525–526):

> The adoption and ratification of the Forty-fourth Amendment under these circumstances renders imperative the inference that the word "income" was there used with the purpose of setting at rest any doubt about the full and complete power of the Legislature to deal with "income" as a subject of taxation. That word was employed to express a comprehensive idea. If is not to be given a narrow or constricted meaning. It must be interpreted as including every item which by any reasonable understanding can fairly be regarded as income. * * *

And even after this Court's decision in *Eisner* v. *Macomber*, the Massachusetts court adhered to its prior decision. *Lanning* v. *Tax Commissioner*, 247 Mass. 496. See also *People ex rel. Pullman Co.* v. *Glynn*, 130 App. Div. 332, affirmed, 198 N. Y.

605. The Supreme Court of Wisconsin likewise followed the approach of the Massachusetts court, in preference to the result in *Eisner* v. *Macomber*, saying (*State ex rel. Dulaney* v. *Nygaard*, 174 Wis. 597, 607–608):

> It seems to us incredible that they [the legislature and the people] expected that the gains of stockholders in corporations should be increased indefinitely and that the liability of those gains to taxation should depend upon the manner in which boards of directors should declare the profits. It seems far more consistent with the general purpose of the amendment that they were considering substance rather than form and that they did not intend that the advantages and gains of stockholders derived from their investments should remain free from taxation, while other citizens, perhaps less able to pay, should bear the burden.

The foregoing considerations point inevitably to the conclusion that whatever philosophic or technical arguments may be advanced to show that stock dividends are not income for some purposes,[11] it has long been widely and popularly understood that such dividends, when based upon corporate earnings, may constitute income. And it is in the

[11] Cf. *Gibbons* v. *Mahon*, 136 U. S. 549, and the discussion with respect to the issues raised by that case in the dissent of Mr. Justice Brandeis in *Eisner* v. *Macomber*, 252 U. S. at 234–236.

light of these considerations that the Sixteenth Amendment should be read. As was stated by Mr. Justice Holmes in his dissent in *Eisner* v. *Macomber*, 252 U. S. at 220:

> The known purpose of this Amendment was to get rid of nice questions as to what might be direct taxes, and I cannot doubt that most people not lawyers would suppose when they voted for it that they put a question like the present to rest. * * *

2. The tax may be sustained upon grounds that are even more fundamental. For, as we shall endeavor to show, Congress has the authority to tax the stockholder on his pro rata share of his corporation's earnings, whether or not they have actually been distributed. In the last analysis, a corporation is an association of persons formed for the purpose of conducting an enterprise,[14] and there is no reason under the Constitution why Congress may not require those who are beneficially interested in the enterprise to account for its earnings regardless of whether they have in fact been segregated for distribution. The stockholder's pro rata share of those earnings may constitutionally be treated as "income" to him, and, *a fortiori*, it may constitute income to him in the constitutional sense when embodied in a stock dividend.

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[14] See *Marshall* v. *Baltimore and Ohio Railroad Co.*, 16 How. 314, 327; Morawetz, Private Corporations (Second Edition, 1886), Volume 1, preface; Hohfeld, Nature of Stockholders' Individual Liability for Corporation Debts, 9 Col. L. Rev. 285 (1909).

A strong analogy is furnished in the case of partnerships. The revenue acts have consistently provided that partners shall be taxed upon their distributive share of the partnership profits, whether or not the profits are in fact distributed, and whether or not the partnership has a separate juristic personality under applicable state law. Nor is it any answer to say that a partner may always call for his share of the profits as opposed to a stockholder who must await the action of the appropriate corporate officers. For, this Court has already held that a partner is chargeable with his allocable share of the partnership earnings, even though they could not in fact be distributed to him under applicable state law. *Heiner* v. *Mellon*, 304 U. S. 271. Mr. Justice Brandeis thus summarized the issue (304 U. S. at 280–281):

> The Mellons contend that under the law of Pennsylvania no distribution of profits could lawfully have been made by the surviving partners as liquidating trustees until all debts and liabilities, contingent or otherwise, had been paid or satisfied, and the partners' capital returned; and that although the business of the partnerships had been carried on after dissolution precisely as before, and the partnership accounts for the year 1920 showed large profits earned, their respective shares of them were not distributable and could not be deemed taxable income of the partners.

Section 218 (a) of the Revenue Act of 1918 provides that "There shall be included in computing the net income of each partner his distributive share, whether distributed or not, of the net income of the partnership for the taxable year . . . ." If "distributive" meant "currently distributable under state law," the contentions made by the Mellons might have some force. But it does not. Article 322 of Regulations 45 (and corresponding articles of subsequent Regulations) defines "distributive" as meaning "proportionate." Compare *Earle* v. *Commissioner*, 38 F. (2d) 965, 967–68 (C. C. A. 1). And § 220 of the Revenue Act of 1918, taxing to the shareholders the income of a corporation improperly accumulating its gains and profits for the purpose of avoiding surtax, assumes that the two words are synonymous. *The tax is thus imposed upon the partner's proportionate share of the net income of the partnership, and the fact that it may not be currently distributable, whether by agreement of the parties or by operation of law, is not material.* * * * [Italics supplied.]

In states where a partnership is treated as a separate entity there is little difference between such a business association and a corporation. The analogy may be made more complete by considering such a partnership with one or more limited partners. In substance the limited partner would be in very much the same position with

respect to the profits of the business as a shareholder in a corporation. Unless the other partners agree to a distribution of the profits, his distributive share is hardly more accessible to him than a shareholder's equitable interest in his corporation's earnings. Yet it is not open to serious dispute that the partner is taxable upon his allocable share of the profits; and there should be no greater obstacle under the Constitution to a similar tax upon stockholders.

Moreover, a tax upon stockholders with respect to corporate earnings is not without precedent. Several of the Civil War income tax acts specifically taxed corporate earnings directly to the stockholders, whether distributed or not. Although the tax was challenged, it was sustained by this Court in *Collector* v. *Hubbard*, 12 Wall. 1, 18:

> But the decisive answer to the proposition is that Congress possesses the power to lay and collect taxes, duties, imposts, and excises, and it is as competent for Congress to tax annual gains and profits before they are divided among the holders of the stock as afterwards, and it is clear that Congress did direct that all such gains and profits, whether *divided or otherwise*, should be included in estimating the annual gains, profits, or income liable to taxation under the provisions of that act.

To be sure, the majority opinion in *Eisner* v. *Macomber* stated that the *Hubbard* case had been overruled by the *Pollock* case; yet it seems quite

clear that even if that were true, the Sixteenth Amendment in turn deprived the *Pollock* case of that consequence. Moreover, the *Hubbard* case had been cited with approval in at least several cases after the *Pollock* decision. See *Southern Pacific Co.* v. *Lowe*, 247 U. S. 330, 336; *Lynch* v. *Turrish*, 247 U. S. 221, 228. See also *Lynch* v. *Hornby*, 247 U. S. 339, 343. But still more significantly, the Court has in recent years again indicated that Congress might frame a tax law which would tax corporate income directly to the shareholders. *Helvering* v. *Nat. Grocery Co.*, 304 U. S. 282, 288. Cf. *McCreery* v. *McColgan*, 17 Cal. (2d) 555. And in a variety of instances, both Congress [15] and this Court [16] have taken into account

[15] The provisions relieving intercorporate dividends in large part from tax recognize the essential character of a corporation. See Internal Revenue Code, Section 26 (b). Compare the provisions relieving dividends received by individuals from normal tax. Section 216 (a) of the Revenue Acts of 1921, 1924, and 1926; Section 25 (a) (1) of the Revenue Acts of 1928, 1932, and 1934. And the provisions relating to consolidated returns for affiliated corporations likewise disregarded the corporate fiction to a rather considerable extent. See Section 240 of the Revenue Acts of 1918, 1921, 1924, and 1926; Section 141 of the Revenue Acts of 1928, 1932, 1934, 1936, 1938, and the Internal Revenue Code.

[16] *Higgins* v. *Smith*, 308 U. S. 473; *Griffiths* v. *Commissioner*, 308 U. S. 355; *Southern Pacific Co.* v. *Lowe*, 247 U. S. 330; *Gulf Oil Corp.* v. *Lewellyn*, 248 U. S. 71. Cf. *United States* v. *Lehigh Valley R. R. Co.*, 220 U. S. 257, 272–274; *Chicago, M. & St. P. Ry. Co.* v. *Minn. Civic Assn.*, 247 U. S. 490, 500–501; *United States* v. *Reading Co.*, 253 U. S. 26; *Northern Securities Co.* v. *United States*, 193 U. S. 197; *Standard Oil Co.* v. *United States*, 221 U. S. 1, 75; *United States* v. *U. S. Steel Corp.*, 251 U. S. 417.

the essential nature of a corporation as the alter ego of its shareholders in determining tax liability.

The facts of the instant case furnish a striking example for the consideration of this question. The petitioner is the sole stockholder and has been conducting a profitable business through his corporation. In truth and in substance, as the corporation has been earning money the petitioner has been earning that money, and we submit that there is nothing in the Constitution that forbids Congress to treat those earnings as belonging to the petitioner without awaiting any formal distribution to him. And if Congress has the power to require a stockholder to account annually for his pro rata share of the corporate earnings, surely it has the lesser power of charging him with the earnings at such convenient times as they may be segregated and made the basis for a stock dividend. Viewed in terms of constitutional power the taxation of corporate profits to the shareholders at the time of a stock dividend merely amounts to a postponement of the reckoning between the shareholder and the Government—a reckoning which Congress could have required at an earlier time.

3. We have contended above that the decision in *Eisner* v. *Macomber* not only misconceived the broad scope of the taxing power under Article I but that it failed to recognize the known purpose of the Sixteenth Amendment. In addition, the decision has introduced various concepts and re-

finements as to the "realization" of "income" which are demonstrably erroneous in the light of subsequent decisions of this Court.

(a) The majority opinion in *Eisner* v. *Macomber* stated the rationale of the decision as follows (252 U. S. at 211):

> The essential and controlling fact is that the stockholder has received nothing out of the company's assets for his separate use and benefit; on the contrary, every dollar of his original investment, together with whatever accretions and accumulations have resulted from employment of his money and that of the other stockholders in the business of the company, still remains the property of the company, and subject to business risks which may result in wiping out the entire investment. * * *

But later decisions of this Court have utterly destroyed the theory that there can be no income to the shareholder unless there is an "outgo" from the corporation. Thus, *Koshland* v. *Helvering*, 298 U. S. 441, ruled that a distribution of common stock to preferred stockholders resulted in income to the distributees notwithstanding that the corporation did not in any way part with any of its assets. A like result was reached in *Helvering* v. *Gowran*, 302 U. S. 238, where preferred stock was issued to the common stockholders. Cf. *Doerschuck* v. *United States*, 274 Fed. 739 (E. D. N. Y.) (distribution of bonds); *United States* v. *Fuller*, 42 F.

(2d) 471 (E. D. Pa.) (same). In neither the *Koshland* nor the *Gowran* case did the stockholder receive anything "out of the company's assets." And in both cases the original investment together with accretions and accumulations remained the "property of the company, and subject to business risks which may result in wiping out the entire investment." The critical consideration, however, is that the corporation in each case had earnings against which the stock dividend could be allocated, and it was appropriate at that time to charge the stockholder with his share of those corporate earnings.

Indeed the foregoing test laid down in *Eisner* v. *Macomber* was repudiated even before the *Koshland* and *Gowran* cases. *United States* v. *Phellis*, 257 U. S. 156; *Rockefeller* v. *United States*, 257 U. S. 176; *Cullinan* v. *Walker*, 262 U. S. 134; *Marr* v. *United States*, 268 U. S. 536; but cf. *Weiss* v. *Stearn*, 265 U. S. 242.

In the *Phellis* case, each shareholder of a New Jersey corporation received two shares of stock in a newly formed Delaware corporation for each share held in the New Jersey corporation, without surrendering the original stock. All of the assets of the New Jersey corporation were transferred to the Delaware corporation. The Court of Claims, following *Eisner* v. *Macomber*, held that the receipt of the new stock did not constitute income. This Court reversed, notwithstanding that the new

corporation was formed to continue the same business that had been carried on by the old corporation; that there was no change in the corporate objects and purposes or in the personnel of the officers or stockholders; and that there was no change in the proportionate interest of any stockholder, the aggregate of the new and old shares representing interests of the same extent in the same enterprise. The *Rockefeller* case presented substantially similar facts, except that the new corporation was formed in the same state as that of the old, and only part of the business was transferred to it.

In *Cullinan* v. *Walker,* a Texas corporation dissolved and the trustees organized two new Texas corporations to which the assets were distributed in exchange for all of the stock and bonds of the new companies. These securities were then exchanged for stock of a newly formed Delaware holding corporation, which stock, together with the bonds of the two new Texas corporations, was distributed to the shareholders of the original Texas corporation. Those shareholders were held to have realized income upon the acquisition of the new stock.

In *Marr* v. *United States,* a shareholder who held both common and preferred stock in a New Jersey corporation received from a newly formed Delaware corporation, to which all of the assets of the old corporation had been transferred, five

shares of common stock in exchange for each share of New Jersey common, and one and one-third preferred shares in exchange for each share of New Jersey preferred. The exchange was held to have constituted a realization of income.

In none of these cases was there any distribution of the assets of the corporation to its shareholders. There was no "outgo." The assets, or part of them, were merely transferred from one company to another identical in composition and business purpose, and the shareholders' formal evidences of their interests in the business, which interests had undergone no substantive change, were corrected correspondingly.

Formal distinctions of the character manifested by *Eisner* v. *Macomber*, on the one hand, and the *Phellis*, *Rockefeller*, *Cullinan*, *Marr*, *Koshland*, and *Gowran* cases, on the other hand, have, we submit, no basis in the broad language of the Sixteenth Amendment, which was intended "to get rid of nice questions as to what might be direct taxes" (Holmes, J., p. 220, dissenting in *Eisner* v. *Macomber*). The subtle refinements between different kinds of stock dividends might support differences in legislative treatment, but such distinctions do not afford grounds for a restrictive construction of a constitutional provision, especially one whose generating motives are like those which gave rise to the Sixteenth Amendment.

(b) The majority opinion in *Eisner* v. *Macomber* also laid down the erroneous requirement that

even though there be actual gain it cannot be treated as "income" under the Sixteenth Amendment unless it is "severed from" capital and available to the recipient for his "separate" use. Thus, it was stated (252 U. S. at 207):

> Here we have the essential matter: *not* a gain *accruing to* capital, not a *growth* or *increment* of value *in* the investment; but a gain, a profit, something of exchangeable value *proceeding from* the property, *severed from* the capital however invested or employed, and *coming in*, being *"derived,"* that is, *received* or *drawn by* the recipient (the taxpayer) for his *separate* use, benefit and disposal;—*that* is income derived from property. Nothing else answers the description. [Italics in original.]

We submit that such restriction upon the broad language[11] of a constitutional provision was

[11] The majority opinion fastened upon the word "derived" in the Sixteenth Amendment as indicating that the gain or profit must be "severed" before it can be treated as income (252 U. S. at 207–208). But that approach involved a distortion of the amendment as a whole, and ignored its well-known purpose. It will be recalled that the Amendment was adopted in response to the *Pollock* case which had held that certain income could not be taxed without apportionment by reason of its source. The Sixteenth Amendment undertook to do away with that result, and provided that income could be taxed without apportionment "from whatever source derived." These were sweeping words, indicating that the apportionment requirement was not to apply to any kind of income whatever. It seems ironic that these words, which were intended to expand the power of Congress, were converted by the majority into words of limitation.

wholly unwarranted, as has since been shown by numerous decisions of this Court. Thus, it has often been held that taxable income may be involved when neither money nor property has been received. The accrual of such benefits as the discharge of the taxpayer's indebtedness,[18] or the payment of his taxes by another,[19] or the satisfaction of other obligations[20] or even the discharge of a mere "social duty",[21] has consistently been treated as taxable income.

Similarly, in *United States* v. *Kirby Lumber Co.*, 284 U. S. 1, it was held that the "book" profit resulting from a corporation's purchase and retirement of its own bonds for less than the amount at which they were issued constitutes income. And the doctrine of the *Kirby* case has even been extended to a situation where the taxpayer's obligations had originally been issued for property rather than money. *Helvering* v. *American Chicle Co.*, 291 U. S. 426. In that case, the discharge of the obligations at less than par was held to consti-

[18] *United States* v. *Hendler*, 303 U. S. 564; *Duffin* v. *Lucas*, 55 F. (2d) 786 (C. C. A. 6th), certiorari denied, 287 U. S. 611.

[19] *Old Colony Tr. Co.* v. *Commissioner*, 279 U. S. 716.

[20] *Douglas* v. *Willcuts*, 296 U. S. 1; *Helvering* v. *Schweitzer*, 296 U. S. 551; *Helvering* v. *Blumenthal*, 296 U. S. 552; *Helvering* v. *Fitch*, 309 U. S. 149; *Helvering* v. *Leonard*, 310 U. S. 80.

[21] *Burnet* v. *Wells*, 289 U. S. 670. See also *Helvering* v. *Clifford*, 309 U. S. 331; *Helvering* v. *Horst*, 311 U. S. 112; *Helvering* v. *Eubank*, 311 U. S. 122; *Lucas* v. *Earl*, 281 U. S. 111.

tute income in the amount of the difference, not a mere reduction in the purchase price of the property, as held by the lower court.[22] Indeed, even the *purchase* of property at a price less than its fair market value may, in some circumstances, be treated as an income producing transaction, or more accurately, as a point at which it is appropriate to measure the taxpayer's increase in wealth.[23]

Whatever residual doubt there may have been as to the unsoundness of the "severability" requirement set forth in *Eisner* v. *Macomber* has been finally put at rest by *Helvering* v. *Bruun*, 309 U. S. 461. There, a tenant had erected a new building upon leased land and had thereafter defaulted upon the lease. The lessor, who thus recovered not only the land but also the building attached to it, contended that even though the building represented a gain to him it could not be treated as "income" because it was inseparable from his capital (the land) and could be taxed

[22] *Commissioner* v. *American Chicle Co.*, 65 F. (2d) 454 (C. C. A. 2d).

[23] *Robinson* v. *Commissioner*, 59 F. (2d) 1008 (C. C. A. 6th); *Salvage* v. *Commissioner*, 76 F. (2d) 112 (C. C. A. 2d), affirmed, 297 U. S. 106; *Hawke* v. *Commissioner*, 109 F. (2d) 946 (C. C. A. 9th); *Helvering* v. *Commercial Investment Trust Corp.*, 74 F. (2d) 1015 (C. C. A. 2d), affirming, *per curiam*, 28 B. T. A. 143; *Haberman* v. *Commissioner*, 31 B. T. A. 75, affirmed, *per curiam*, 79 F. (2d) 995 (C. C. A. 2d); *Alger-Sullivan Lumber Co.* v. *Commissioner*, 57 F. (2d) 3 (C. C. A. 5th); *Indianapolis Glove Co.* v. *United States*, 96 F. (2d) 816 (C. C. A. 7th); *Bothwell* v. *Commisioner*, 77 F. (2d) 35 (C. C. A. 10th).

only at such time as he might sell it. This Court paid but scant attention to *Eisner* v. *Macomber*, and definitely rejected the concept of "severability" as a limitation upon the meaning of income under the Sixteenth Amendment (p. 469):[24]

> It is not necessary to recognition of taxable gain that he [the taxpayer] should be able to sever the improvement begetting the gain from his original capital. If that were necessary, no income could arise from the exchange of property; whereas such gain has always been recognized as realized taxable gain.

We respectfully submit that the question of "realization" of income is not one which can be appropriately dealt with by a restrictive judicial definition. Fundamentally, the problem is simply one of finding an appropriate time for the measurement of an increase in wealth. That problem is essentially, and by its very nature, legislative in character, and we urge that under the Sixteenth Amendment, which was intended to make possible an equitable system of progressive income taxation, resolution of such questions was placed in the legislative branch of the Government. Congress should be left free to designate any convenient event as appropriate for the measurement of increases in wealth. The concept of

[24] Indeed, so far as ease of disposition is concerned, the recipient of a stock dividend probably could sell it with greater ease than could the lessor in the *Brown* case sell the building without the land.

"realization" should impose no greater restraint than this. The declaration of a stock dividend based upon corporate earnings is certainly an event at which it is appropriate to measure the increase in wealth which has accrued to a stockholder by virtue of the successful operation of the business in which he is beneficially interested.

(c) Another fundamental misconception which appeared to pervade the entire decision in *Eisner* v. *Macomber* was that there could be no income through the distribution of a stock dividend because the stockholder's position after the dividend was the same as before. Of course, we do not contend that the mere declaration of a stock dividend is a wealth producing transaction. The same is true in the case of a cash dividend; for the stockholder is generally no wealthier immediately after the distribution than before, since the payment of the dividend out of the corporate assets reduces *pro tanto* his financial interest in the corporation. The essential fact is that in the normal situation the corporate earnings have been accumulating over a period of time and have gradually enriched the stockholder in proportion to his holdings. And the distribution of the dividend, whether in cash or in stock merely marks a convenient point at which that increase in wealth may be charged against those who are equitably entitled thereto.[25]

[25] Of course, it may be that the stockholder had acquired his stock after the corporation had realized the earnings in question. But the same situation would exist even in the

The profit derived from the increase in value of a capital asset is analogous. Suppose, for example, that a taxpayer has an asset for which he had paid $10,000 but which has risen in value over a period of time so that it becomes worth $20,000. If the taxpayer should sell that asset for $20,000 or should exchange it for some other property of the same value, it is clear that he would be no wealthier immediately after the sale or exchange than immediately before. Yet the sale or exchange marks the time that Congress has selected to require him to account for a gain that had been accruing up to that time. He is taxed, not on the $20,000 which he receives, but only upon the amount of gain reflected therein. Similarly, in the case of corporate dividends, whether in cash or stock, the tax is levied only to the extent that the dividends are

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case of a cash dividend, and it is undisputed that the distribution of a cash dividend out of the corporation's earnings is taxable regardless of when the recipient became a stockholder. Cf. *Lynch* v. *Hornby*, 247 U. S. 339; *Peabody* v. *Eisner*, 247 U. S. 347; *United States* v. *Phellis*, 257 U. S. 156. Since Congress has provided for the postponement of taxing the corporate earnings to the stockholders until there has been a dividend, it is necessary in order to preserve continuity, that each new stockholder be treated as stepping into the shoes of his predecessor. The principle is one that has long been familiar in our revenue laws, and has been approved by this Court in the analogous situation where the owner of property is in some circumstances required to take over the basis of his predecessor for the purpose of computing gain or loss upon sale. *Taft* v. *Bowers*, 278 U. S. 470; *Cooper* v. *United States*, 280 U. S. 409.

based upon earnings. Naturally, there would be no income to a stockholder if the corporation had no earnings and there were a 10 for 1 split-up of its shares. We make no such fantastic contention. We say merely that the declaration of a stock dividend marks the time which Congress may select as the occasion to reckon the gain that has been accruing to stockholders through the earnings of their corporation.[26]

[26] Although we contend that a stock dividend based upon corporate earnings may be treated as income under the Sixteenth Amendment even if it results in no essential change in the stockholder's position, it is obvious that it may effect a material change in his rights. The holder of a $100 share in a corporation has the right to have that sum retained in the business as capital. If a 100 percent stock dividend is paid, he now has the right to have $200 retained in the business as capital. The prior surplus can no longer be used for dividends, nor can it be used to purchase the corporation's own shares. The consent of a large proportion of the shareholders, and perhaps of the creditors or a court, is now required to reduce the capital stock and recreate the surplus. See Fletcher, Cyclopedia Corporations, Volume 11 (1932), Sections 5149, 5150. If the corporation's borrowing power is limited by the amount of its capital stock (see Fletcher, *supra*, Volume 6 (1931), Section 2615, fn. 65), the dividend has increased the borrowing power correspondingly. Concomitantly new obligations may have been created. Many state statutes impose personal liability upon shareholders for certain kinds of corporate debts and generally the liability is measured by the par or stated value of the stock held by each shareholder. See Fletcher, *supra*, Volume 13 (1932), Section 6277. A stock dividend increases this potential liability *pro tanto*.

C. *Eisner* v. *Macomber* should be expressly overruled

If, as we contend, *Eisner* v. *Macomber* was erroneously decided, then we submit that it should be expressly overruled. Although the distinctions made by the later cases have considerably narrowed the operative scope of that decision, the process of limitation has now reached the point where it has become exceedingly difficult to reconcile the basic theories of the decided cases.[27] An additional distinction will but serve further to obfuscate the basic issue, and to accentuate the need for the inevitable remedy which only this Court can provide in such a situation.

Of even greater moment is the hampering influence which the decision has cast upon the legislative development of an effective method of taxing corporate earnings. It has been a chronic and most difficult problem to achieve equality of the ultimate thrust of the tax burden upon persons in the same income levels. For example, it was estimated that the insulation between corporate earnings and indi-

[27] Illustrative of the confusion produced by *Eisner* v. *Macomber* is the fact that Congress thereafter specifically exempted all stock dividends from tax, thinking that such a sweeping exemption was constitutionally required by the decision. See *Koshland* v. *Helvering*, 298 U. S. 441, 444–445, and discussion, *supra*, pp. 10–11. It was not until after the *Koshland* decision, some fifteen years later that Congress in Section 115 (f) of the Revenue Act of 1936 substituted a provision making taxability of such dividends coextensive with constitutional powers, thereby leaving the question to the courts.

vidual surtax would result in a loss of more than 600 million dollars in revenue in 1937. See S. Rep. No. 2156, 74th Cong., 2d Sess., part 2, p. 2. It was also pointed out that a converse effect was to place a disproportionately heavy burden upon small stockholders in low income levels. The undistributed profits tax under the Revenue Act of 1936 was an unsuccessful attempt to correct some of these inequities.

Other methods might be attempted if it were made clear that *Eisner* v. *Macomber* did not stand in the way. For example, the decision impelled Congress to abandon the taxation to the shareholders of the profits of a corporation formed or availed of for the purpose of avoiding surtax, and the similar method of taxing the profits of personal service corporations. See H. Rep. No. 350, 67th Cong., 1st Sess., pp. 12, 16; S. Rep. No. 275, 67th Cong., 1st Sess., pp. 16, 34. Compare the provisions of Section 337 of the Internal Revenue Code relating to foreign personal holding companies, where Congress has undertaken to tax corporate earnings directly to the stockholder in order to prevent avoidance. Conceivably if it were freed of the restrictive effect of *Eisner* v. *Macomber*, Congress might adopt some such method of taxing earnings of domestic corporations.[28] In any event

[28] See H. Rep. No. 1860, 75th Cong., 3d Sess., pp. 2–3 (1939–1 Cum. Bull. (Part 2) 728, 729):

> Much tax avoidance had undoubtedly occurred in years prior to 1936, by the avoidance of individual

it is of the utmost public importance that Congress be free to develop fiscal policies unhampered by the shadow of erroneous constitutional limitations. Only a complete excision of *Eisner* v. *Macomber* from the body of constitutional law can accomplish this result, for obviously no system of taxation may be adopted as a major part of the fiscal scheme so long as there exists even a doubt as to its ultimate fate in the courts.

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surtaxes through the retention of profits by corporations when such retention was unnecessary.

The opportunity for such tax avoidance in this manner has long been recognized. It may be that this was one of the reasons why, in the Civil War Income Tax Act of 1864, the general rule was to tax corporate profits to the shareholder whether or not such profits were distributed to him. In the light of court decisions since that time, there is some support for the contention that this system of taxation is unconstitutional for domestic corporations.

Several commentators have thought that *Eisner* v. *Macomber* precluded such a system of taxation for domestic corporations; see Ballantine, Corporate Personality in Income Taxation, 34 Harv. L. Rev. 573, 581 (1921); Seligman, Implications and Effects of the Stock Dividend Decision, 21 Col. L. Rev. 313, 323 (1921); Martin, Taxation of Undistributed Corporate Profits, 35 Mich. L. Rev. 44, 45 (1936); although the contrary view has also been expressed: see Powell, The Stock Dividend Decision and the Corporate Nonentity, 5 Nat. Tax Assn. Bull. 201 (1920); Clark, *Eisner* v. *Macomber* and Some Income Tax Problems, 29 Yale L. J. 735, 742 (1920); Traynor, Tax Decisions of the Supreme Court, 1937 Term, 33 Ill. L. Rev. 371, 388 (1938).

II

THE DECISION BELOW IS CORRECT EVEN IF EISNER V. MACOMBER BE PERMITTED TO STAND

As an alternative argument we submit, as held by the court below,[a] that the decision below is correct even if *Eisner* v. *Macomber* be not overruled. This case falls within the doctrine of *Koshland* v. *Helvering*, 298 U. S. 441, and *Helvering* v. *Gowran*, 302 U. S. 238. In the *Gowran* case, as here, there was a dividend of preferred stock on common. It is true that in the *Gowran* case there was some preferred stock outstanding at the time the dividend was declared, but we do not believe that fact to be of controlling significance. On the contrary, the important fact is that the distribution of a new kind of stock gives the recipient rights which are of a different character from those which he previously owned.[b]

In the instant case, as the Board pointed out (R. 16–17), the new stock differed substantially from the old. Since the new stock carries no voting rights it might be disposed of without affecting

[a] A contrary result was reached in *Dreyfuss* v. *Manning*, 44 F. Supp. 383 (N. J.), now on appeal to C. C. A. 3d.

[b] In this connection it is to be noted that in neither the *Koshland* nor the *Gowran* opinion was emphasis placed upon the fact that more than one class of stock was outstanding at the time the dividend was declared. In each instance the fact was merely noted without comment. In *Helvering* v. *Pfeiffer*, 302 U. S. 247, a companion proceeding to the *Gowran* case, the fact was not even mentioned.

petitioner's control of the corporation. It carries with it the right to the payment of a fixed annual amount before dividends may be paid upon the common stock, and this right is cumulative. All of these new rights may be disposed of without affecting the petitioner's preexisting interest as the holder of the common stock. It cannot be said therefore that the stock dividend was a mere proliferation of an existing interest.

It is true that there was no change in the petitioner's proportionate interest in the assets of the corporation, but that should not be of importance since the test is as follows (*Koshland* v. *Helvering*, *supra*, at p. 446): "where a stock dividend gives the stockholder an interest different from that which his former stockholdings represented he receives income." See also *Helvering* v. *Gowran*, *supra*, at 240–241.

To be sure a stock dividend which worked a change in a stockholder's proportionate interest in the corporation's assets would also constitute a taxable dividend, but we submit that *either* such a change in interest *or* the receipt of different rights brings a case within the rule of the *Koshland* decision.[21] Indeed, if the test were that there *must* be a change in proportionate interest, a dividend paid in cash would not constitute income.

[21] See *Helvering* v. *Midland Ins. Co.*, 300 U. S. 216, 225: "Income may be realized upon a change in the nature of legal rights held, though the particular taxpayer has enjoyed no addition to his economic worth."

CONCLUSION

The judgment below should be affirmed.

Respectfully submitted.

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APPENDIX

Constitution of the United States:

Article I, Section 2, Clause 3.—Representatives and direct Taxes shall be apportioned among the several States which may be included within this Union, according to their respective Numbers, which shall be determined by adding to the whole Number of free Persons, including those bound to Service for a Term of Years, and excluding Indians not taxed, three fifths of all other Persons. * * *

Article I, Section 8, Clause 1.—The Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States;

Article I, Section 9, Clauses 4 and 5.—No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken.

No Tax or Duty shall be laid on Articles exported from any State.

* * * * *

Sixteenth Amendment.—The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from * * * dividends, * * *.

* * * * *

(d) *Distributions by Corporations.*—Distributions by corporations shall be taxable to the shareholders as provided in section 115.

* * * * *

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this title * * * means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

(b) *Source of Distributions.*—For the purposes of this Act every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. * * *

* * * * *

(f) *Stock Dividends.* —

(1) *General Rule.*—A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution.

* * * * *

(j) *Valuation of Dividend.*—If the whole or any part of a dividend is paid to a shareholder in any medium other than money the property received other than money shall be included in gross income at its fair market value at the time as of which it becomes income to the shareholder.

Treasury Regulations 94, relating to the Revenue Act of 1936:

ART. 115–7. [The material reproduced herein represents Article 115–7 as it was originally promulgated. However, by T. D. 5110, *infra*, only the first sentence now remains.] Stock dividends.—A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall be treated as a dividend to the full extent that it constitutes income to the shareholders within the meaning of the sixteenth amendment to the Constitution. The Supreme Court has pointed out some of the characteristics distinguishing a stock dividend which constitutes income from one which does not constitute income within the meaning of the Constitution.[1] The distinction between a stock dividend which does not, and one which does, constitute income to the shareholder within the meaning of the sixteenth amendment to the Constitution is

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[1] See *Eisner* v. *Macomber* (252 U. S., 189, T. D. 3010, C. B. 3, 25); and *Koshland* v. *Helvering* (56 Sup. Ct., 767, Ct. D. 1124, C. B. XV-1, 219). Compare *United States* v. *Phellis* (257 U. S., 156, T. D. 3270, C. B. 5, 37); *Rockefeller* v. *United States* (257 U. S., 176, T. D. 3271, C. B. 5, 34); *Cullinan* v. *Walker* (262 U. S., 134, T. D. 3508, C. B. 11–2, 355); *Weiss* v. *Stearn* (265 U. S., 242, T. D. 3609, C. B. III–2, 51); and *Marr* v. *United States* (268 U. S., 536, T. D. 3755, C. B. IV–2, 116).

the distinction between a stock dividend which works no change in the corporate entity, the same interest in the same corporation being represented after the distribution by more shares of precisely the same character, and a stock dividend where there either has been a change of corporate identity or a change in the nature of the shares issued as dividends whereby the proportional interest of the shareholder after the distribution is essentially different from his former interest. A stock dividend constitutes income if it gives the shareholder an interest different from that which his former stock holdings represented. A stock dividend does not constitute income if the new shares confer no different rights or interests than did the old—the new certificates plus the old representing the same proportionate interest in the net assets of the corporation as did the old.

Example (1): The X Corporation had an authorized capital stock of $300,000 of common stock, par value $10 a share, and $100,000 of 7 percent cumulative preferred stock, par value $100 a share, which is preferred as to dividends, has no voting rights, and may be redeemed at any time at $105 per share. The articles of incorporation provide that the annual dividend on the preferred stock may be paid in cash or, at the option of the corporation, in one share of common stock for each share of preferred. On July 1, 1936, the X Corporation had outstanding $200,000 of common stock and $100,000 of preferred stock, earnings and profits of $60,000 accumulated since February 28, 1913, and earnings and profits of the taxable year amounting to $15,000. On July 1, 1936, it distributed

1,000 shares of its common stock of an aggregate par value (and fair market value) of $10,000 to the holders of its preferred stock in payment of the annual dividend on such stock. The stock so distributed constitutes a taxable stock dividend to the holders of the preferred stock.

Example (*2*): On July 1, 1936, the Y Corporation had an authorized capital stock consisting of 1,000 shares of common stock, par value $100 a share, of which 500 shares were outstanding. It had earnings and profits of $40,000 accumulated since February 28, 1913, and $5,000 of earnings and profits of the taxable year. On July 1, 1936, the Y Corporation issued and divided among its shareholders 250 additional shares of its common stock of a total par value of $25,000 and transferred an equivalent amount from surplus account to capital stock account. The stock so distributed does not constitute a taxable stock dividend to the shareholders.

Example (*3*): The Z Corporation had an authorized capital stock of 30,000 shares of common, without par value, and 10,000 shares of 7 percent-cumulative preferred stock, par $100, which is preferred as to dividends, has voting rights and may be redeemed on the 1st of January or July of any year by the payment of $105 per share and accrued dividends. On July 1, 1936, the company's issued and outstanding stock amounted to 20,000 shares of common and 6,000 shares of preferred, and it had $250,000 earnings and profits accumulated since February 28, 1913, and $90,000 earnings and profits of the taxable year. On July 1, 1936, it paid a dividend on its common stock in preferred stock at the rate of 1/10 share

of preferred on each share of common outstanding. The preferred stock so distributed constitutes a taxable stock dividend to the holders of common stock.

T. D. 5020, 1940–2 Cum. Bull. 118:

Section 19.115–7 of Regulations 103 [Part 19, Title 26, Code of Federal Regulations, 1940 Sup.] is amended by striking out all of the matter appearing after the first sentence thereof.

T. D. 5110, 1942–4 Int. Rev. Bull. 7:

Article 115–7 of Regulations 94 [section 3.115–7, Title 26, Code of Federal Regulations] and article 115–7 of Regulations 101 [section 9.115–7, Title 26, Code of Federal Regulations, 1939 Sup.] are each amended by striking out all of the matter appearing after the first sentence thereof.

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Supreme Court of the United States.

OCTOBER TERM, 1942.

No. 66.

EMIL H. STRASSBURGER, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE.

ON A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.

BRIEF OF AMICI CURIAE.

NATHAN BILDER,
WALTER J. BILDER,
ERWIN N. GRISWOLD,
Amici Curiae.

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BRIEF OF AMICI CURIAE.

This brief is filed by counsel who represent the taxpayer in the case of *Leonard Dreyfuss* v. *John E. Manning, Collector*, 44 F. Supp. 383, in which an appeal by the Government from the decision of the District Court for the District of New Jersey is now pending before the Circuit Court of Appeals for the Third Circuit. That case involved a distribution of preferred stock made by a corporation which had only common stock outstanding, all of which was owned by one person. The District Court held that it was not a taxable dividend.

It is not the purpose of this brief to examine the several authorities bearing upon the taxability of stock dividends. It is rather intended to suggest some arguments relating to

the construction of the statute involved in this case. That statute is § 115(f)(1) of the Revenue Act of 1936, which reads as follows—

> A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution.

I.

The Generality of the Statute.

This statute does not define in terms the stock dividends which shall be taxable. It does not say "All stock dividends shall be taxable." It does not say "All stock dividends shall be taxable when they are paid in a different class of stock from that previously outstanding." It does not say "All dividends paid in preferred stock to the holders of common stock shall be taxable even though only common stock was outstanding and that was held by a single person." It does not say that "Stock dividends shall be taxable when they give the stockholder a different proportionate interest than he had before." It does not say that "Stock dividends shall be taxable when they give the stockholder a different interest, regardless of any change in proportionate interest." On the contrary, what it does say is that whether a stock dividend is taxable shall depend upon the views which this Court may take of the meaning of the word "income" in the Sixteenth Amendment, without any expression by Congress itself as to what it regards as the extent of its powers under that Amendment.

In the allocation of the powers of Government, certain matters have been regarded as basically legislative. These

include the power to define crimes, and to determine the limits of punishment for crimes. The power to levy taxes has also been a peculiarly legislative power. It is the first power conferred expressly upon "The Congress" by Article I, Section 8, of the Constitution. Of course, this does not mean that Congress cannot make delegations of authority with respect to taxes. Such delegations to administrative officers are frequent and familiar. Cf. *Field* v. *Clark*, 143 U.S. 649; *J. W. Hampton, Jr. & Co.* v. *United States*, 276 U.S. 394; and the powers of the Commissioner of Internal Revenue to make regulations. But in all of these cases, the responsibility is on Congress. The duties of the officers to whom delegations are made are to ascertain facts, or to prescribe details within "canalized" limits. They do not purport to delegate the determination of an ultimate question of constitutional power.

It may be said that the delegation here is made in effect to the judiciary, and it is the function of the judiciary to determine questions of constitutional law. It is the function of the judiciary to construe statutes, to determine as near as may be what was the meaning of the legislative authority. But it is not the function of the judiciary to rewrite statutes, to give them meaning when the Congress has not undertaken itself to draw the lines to which its legislation shall apply. If Congress says such and such shall be taxable, it is the function of this Court to determine whether that falls within the Congressional power. But if Congress says, we levy a tax on what we can, and leave it to the courts to determine, Congress has not fulfilled its responsibility under the Constitution to "lay" taxes.

It is certainly clear that Congress could not validly pass a general statute saying in substance, "There is hereby imposed a tax on every subject to which our constitutional powers extend." The present statute is not as broad as

this. It relates to only one aspect of constitutional power in the taxation field. But on the matter to which it does relate, it lays down no judgment of Congress as to the extent of its power. It leaves the Court the duty not of determining the validity of a power exercised by Congress, but of determining the extent of Congressional power when Congress has made no determination itself. This Court is entitled to have the judgment of Congress on the question how far Congress thinks its powers under the Constitution extend.

II.

The Construction of the Statute.

A. *A General Statute Need Not Be Construed to Reach to the Limits of Congressional Power.*

The Court would hardly hold that a statute such as this was unconstitutional. The question of the proper construction of the statute which Congress has enacted must, however, be decided. Though every possible presumption should be exercised in favor of the constitutionality of a statute, there is no similar rule as to the construction of the statute. If Congress choses to legislate in indefinite and uncertain terms, there is no obligation on the courts to push the words used to extreme limits. Indeed, the obligation is to the contrary.

The question presented in this case, therefore, is not the same as it would have been if Congress had legislated specifically that "All stock dividends shall be taxable." In such a case there would have been no question of construction, but merely a question of the validity of the power which Congress had purported to exercise. But under the statute which Congress did pass, there is a question of construction, and this question of construction may well be

affected by a proper regard for the separation of powers. In other words, this Court may find as a matter of construction that the present statute should not be pushed to a point which the Court would find within Congressional power if Congress had expressly so provided in the statute.

The point may be illustrated by an example. Congress might enact a statute, analogous to the one here involved, providing that "All income shall be taxed to a person to the extent of the constitutional power of Congress to tax it to him." Under such a statute, assuming its validity, it seems likely that this Court would find that the income of a revocable trust was taxable to the settlor. It might easily reach the result of *Helvering* v. *Clifford*, 309 U.S. 331, or of *Douglas* v. *Willcuts*, 296 U.S. 1. It is very likely that it would reach the result of *Helvering* v. *Horst*, 311 U.S. 112. But it is submitted that there are situations to which the Court would not apply such a statute, although it would sustain the power of Congress to enact a statute applying to these situations in terms. Thus, in 1924, Congress enacted the provision which is now found in § 167 of the Internal Revenue Code, and which taxes to the settlor the income of a funded insurance trust, although the trust is completely irrevocable and the settlor retains no interest in the trust property, no control over the income, and no other relation to the situation. This express statute was sustained by this Court in *Burnet* v. *Wells*, 289 U.S. 670. It seems at least doubtful whether the income in question in that case would have been held taxable to the settlor under a statute phrased in general terms, as at the beginning of this paragraph. If those doubts are well taken, then the point is made that a general statute of this sort will not exhaust the powers of Congress and will not reach all situations which Congress might itself reach by words expressly chosen for that purpose.

We submit that that is the situation here. When Congress enacted the statute in question it displaced a prior provision which had been in effect for many years, and which provided that "A stock dividend shall not be subject to tax." Section 115(f) of the Revenue Act of 1934. This Court's decision in *Koshland* v. *Helvering*, 298 U.S. 441, showed that the prior statute did not tax certain dividends which might be taxed. It was therefore proper that Congress should seek to tax such dividends. But the *Koshland* case involved a situation where the dividend caused a change in the *proportionate* interests of the shareholders. Congress did not express any clear intent to go farther. Its committee reports are perfectly blank as to the extent to which it thought its general statute did go. See House Report No. 2475, 74th Congress, Second Session, p. 10; Senate Report No. 2156, 74th Congress, Second Session, pp. 18-19. These merely repeat the general language of the statute. The statute does not disclose any express intention to reach the result which was held to be beyond the power of Congress in *Eisner* v. *Macomber*, 252 U.S. 189. *Indeed, the form of the statute indicates plainly the understanding of Congress that there were some stock dividends which it did not have the power to tax.*

We submit that the Court is under no obligation to construe this general statute so as to push the power which Congress has exerted to the ultimate limits of the power which Congress could exert if it expressly undertook to exercise that power. Cf. *Towne* v. *Eisner*, 245 U.S. 418. Under all the circumstances, the only intention that Congress has clearly indicated is that the statute is to apply to stock dividends where there is a change in the *proportionate* interest of the shareholders, as in the *Koshland* case itself. Determination of the question whether Congress can apply the taxing power to the extreme case where there is no change in the proportionate interests of the shareholders,

and where as here there is at all times only a single shareholder—who owns everything, no more and no less, both before and after the transaction—may well be deferred until Congress makes plain its real intention that this Court must reëxamine the solemn determination of *Eisner* v. *Macomber*. If Congress choses to legislate in wholly general terms there is no need for this Court to treat the statute as a roving commission requiring the Court to go into fields where the Congress has not led the way.

B. *Even Though Congress Can Impose an Excise Tax on Stock Dividends, It Does Not Follow That They Are Taxable Under a Statute Imposing the Tax on Income.*

There is another, though related, argument on the question of construction. One of the contentions made by the Government in previous cases, as in the brief [1] and oral argument before this Court in *Helvering* v. *Bruun*, 309 U.S. 461, is, in substance, that a stock dividend may be taxed quite apart from the Sixteenth Amendment, because it is an event which is subject to an excise under the general taxing powers of Congress.

This is a *constitutional* argument. It is an argument that Congress *can* tax stock dividends whether they are income or not, because there is an *event* which Congress can tax. The opinion of the majority below seems to disclose that its conclusion was based in part on this ground. Prior to the transaction in question the petitioner owned all of the stock in the corporation, and he owned all of the stock after the transaction was completed. There was no change in the quantity of his aggregate interests. The conclusion that he was taxable arises from the occurrence of

[1] See pages 23-25 of the Brief for the Petitioner, in *Helvering* v. *Bruun*, No. 479, October Term, 1939.

a change in the quality of the petitioner's stockholdings. Thus the Court shows that what it views as taxable is not property or income but an event or process, namely, "the rearrangement of corporate capitalization" producing a change in the "character" or quality of the stockholder's "corporate ownership." *Strassburger* v. *Commissioner*, 124 F. (2d) 315, at 317. It is the transformation in the legal quality of the stockholding which is being taxed, not the product of that transformation. The total product of the transformation is quantitatively neither more nor less than what the petitioner owned before the change occurred. The difference is only qualitative. But the transforming process itself is obviously not property. It is a process or event, and hence does not constitute "income," which is a thing, or quantity. To tax the transforming process under the guise of taxing its product is to tax something which, although it may possibly be made the proper subject of taxation, is nevertheless not "income."

Thus, though a statute expressly taxing all stock dividends may be constitutional as imposing an excise on an event, that is not the question here. Before this dividend can be taxed, it must be held not only that Congress can tax it under the Constitution, but also that Congress has taxed it under § 115(f)(1) of the Revenue Act of 1936. *But that statute does not purport to tax all stock dividends which Congress can constitutionally subject to taxation.* It does not say "A distribution . . . shall not be treated as a dividend to the extent that it cannot be taxed under the Constitution." That is the way the Government would read it; and if it did so read, the Government's excise argument would be relevant. But as the statute was actually written, the excise argument is self defeating. For the actual provision of the statute is that a distribution shall not be taxable unless it is "income" within the Sixteenth Amendment. Thus, to say that Congress can tax stock

dividends under the general powers of Article I, Section 8, does not meet this case, for Congress, in the statutory language it has actually used, has not purported to exercise those powers. The argument based upon the general taxing powers of Congress is in substance and effect a concession that a stock dividend is not "income," and thus is not within the terms of this statute. For in this statute Congress has in terms undertaken to tax only those things which are income within the Sixteenth Amendment.

This may point the way to an orderly solution of the stock dividend problem. To continue to approach it in terms of "income" leaves us engulfed in a verbal sea. The concept of income cannot be precisely defined. In the stock dividend field, it extends to the situation where a shareholder has received something which changes his proportionate interests in the enterprise. That has been decided in *Koshland* v. *Helvering*, 298 U.S. 441. But it is a great strain to push the concept beyond that point to the situation where there is merely a *different* interest, in that there are more or different pieces of paper, but where there is no change at all in the *proportionate* interests of the shareholders, and especially, where, as here, there is at all times only a single shareholder. That strain is evidenced by *Eisner* v. *Macomber*, and by the nearly twenty years of practice that followed that case. Moreover, if the field is entered, the lines will be very hard to draw, and they will necessarily have to be drawn more or less arbitrarily. If a dividend of preferred on common, with no change of proportionate interest, is taxable, is a dividend of common on common taxable? And if it is, will a mere split-up of common stock result in taxable income? These are knotty questions, some of which the Government is already undertaking to raise. But there is no need for this Court to enter this verbal field, and to undertake the task of forcing the concept of income to new limits, if Congress can constitu-

tionally tax all stock dividends whether they are income or not. This statute taxes only those stock dividends which are income. This Court should feel under no compulsion to hold stock dividends taxable on the ground that they are income if it lies within Congressional power to tax them on other grounds.

Most of the constitutional argument in the stock dividend field has heretofore been cast in terms of income. In order to make stock dividends taxable, it was felt that they had to be regarded as income, and thus there has been great constitutional pressure on that word. But that pressure may be relaxed entirely if Congress has power under Article I, Section 8, to tax stock dividends whether they are income or not. On this basis, the question presented here is not one of constitutional law, but is solely one of statutory construction. The word which Congress used was "income." It can be given a very broad construction, or it can be given the ordinary construction which it has heretofore received, and which has not carried it yet in this Court's decisions beyond the limits of the *Koshland* case. If it were necessary to do so to uphold the constitutional power of Congress, it might be forcefully argued that the broad construction should be reached. But there is no such need to stretch the meaning of the word "income" if the ultimate powers of Congress to tax stock dividends does not turn on the meaning of that word. If Congress could tax all stock dividends if it wanted to and said so, the present statute which taxes only those which are income within the Sixteenth Amendment should be construed so as to avoid the difficult constitutional question as to the precise limits of that Amendment. Cf. *Lucas* v. *Alexander*, 279 U.S. 573, 577; *Reinecke* v. *Northern Trust Co.*, 278 U.S. 329, 348-349; *United States* v. *La Franca*, 282 U.S. 568, 574.

Conclusion.

Before any question of constitutionality need be faced in this case, the statute involved must itself be construed. The statute should not be construed to tax a stock distribution which does not change the proportionate interests of the shareholders, and particularly where, as here, all of the stock was at all times owned by a single shareholder. The statute is in general terms, and need not be construed as a specific direction to tax all stock dividends. Moreover, Congress did not purport to exert its general taxing powers, but only its powers with respect to income under the Sixteenth Amendment. To the extent that Congress may tax stock dividends as an excise on an event, there is no constitutional necessity to strain the meaning of the word "income" as applied to the facts of this case.

Respectfully submitted,

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November, 1942.

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BRIEF AMICUS CURIAE.

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MOTION FOR LEAVE TO FILE BRIEF AMICUS CURIAE.

Comes now the undersigned and moves for leave to file instanter the annexed brief amicus curiae. Counsel for both parties have consented to the filing of this brief.

JOHN E. HUGHES,
105 W. Adams St.
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BRIEF AMICUS CURIAE.

May It Please the Court:

The points made in this brief are (1) that Congress did not intend to tax a dividend of common stock on identical common stock by section 115 (f) (1) of the Revenue Act. (2) That Congress, by the reorganization provisions of the Act postponed the tax on such a stock dividend until it was sold. This court will avoid a constitutional doubt by construction if possible. See cases collected in opinion of Justice Holmes in *Blodgett* v. *Holden*, 275 U. S. at page 148.

If either of the above points is well taken it is unnecessary to consider whether the *Macomber* case was rightly decided. (3) However it is argued herein that it was rightly decided.

The Legislative History of 115 (f) (1) of the Internal Revenue Code Enacted in 1936 Was Not Intended to Tax Stock Dividends Which Were Held Not to Be Income by Eisner v. Macomber, 252 U. S. 189.

Before the enactment of Section 115 (f) (1) of the Revenue Act of 1936, Congress had, since 1921, expressly exempted all stock dividends from tax. *Helvering* v. *Gowran*, 302 U. S. 238.

In *Koshland* v. *Helvering*, decided May 18, 1936, 298 U. S. 441, this court, at pages 445 and 446, restated our constitutional law to be as follows:

"Under our decisions the payment of a dividend of new common shares, conferring no different rights or interests than did the old,—the new certificates, plus the old, representing the same proportionate interest in the net assets of the corporation as did the old,—does not constitute the receipt of income by the stockholder. On the other hand, where a stock dividend gives the stockholder an interest different from that which his former stock holdings represented he receives income. The latter type of dividend is taxable as income under the Sixteenth Amendment."

This decision was inserted in the Congressional Record while Congress was considering the Revenue Act of 1936 (see speech of Senator Black, 80 Cong. Rec. 8811). This speech also recognizes dividends of common on common stock were not taxable.

When Section 115 (f) of the Revenue Act of 1936 was being considered by the House, Representative Vinson, majority member of the Ways & Means Committee which reported the 1936 act, and the member in charge of the bill, was questioned by Mr. Treadway, ranking minority member of the Ways & Means Committee, concerning its purpose and he plainly stated it was not intended by it to tax stock dividends which were held not to be income by *Eisner* v. *Macomber*. This discussion is set forth in 80 Cong. Rec. 6309 and is as follows:

"Mr. Treadway: May I ask the gentleman one question?

"I think he has covered subdivision (j) very thoroughly. Now, referring to section (f), taxable stock dividends, which is, of course, entirely new, that is, the principle is entirely new in that there is a set-up there under which stock dividends can be taxed, which has not been in the previous law. I am correct in that?

"Mr. Vinson of Kentucky. If the gentleman from Massachusetts will permit, under the 1934 act there was a provision that said no stock dividend should be taxed. In a very celebrated case, Eisner against Macomber, the Supreme Court held that the tax dividend involved in that case was not taxable. Out of that case grew up the idea that no stock dividend was taxable. I think it was because of that notion that the language to which I have referred, as appears in the 1934 bill, found its way there; that is, that no stock dividend should be taxed.

"**The proposed plan does not change the law and does not in the slightest degree strike at the decision of the Supreme Court in the case of Eisner and Macomber in respect of a stock dividend where there is no change in the proportion of ownership by the shareholder.**"

Again at page 6214 Congressman Vinson said:

"Existing law provides no stock dividend shall be taxed. We strike them from this bill. There are innumerable types of stock dividends that are taxable under the Constitution and under the celebrated case of *Eisner* v. *Macomber*."

The government's brief in this court in the *Gowron* case (signed by Justice Reed and case argued by Justice Jackson) makes this statement at page 21, after quoting the foregoing:

"The Congressional understanding that the 1936 Act did not change the law is a factor of great weight in construing the prior acts of Congress on the same subject. *Tiger* v. *Western Investment Co.*, 221 U. S. 286, 309. *Cope* v. *Cope*, 137 U. S. 682, 688. *United States* v. *Freeman*, 3 How. 556."

Also, the fact that Section 115 (f) (1), read literally, does not impose any tax but simply declares a super-

fluous rule and thus throws one back for the tax imposing section to the definition of dividend in the Internal Revenue Code brings the case squarely within Justice Holmes' opinion in *Towne* v. *Eisner*, 245 U. S. 418. Note the government's reliance on sec. 22 (Br. p. 10).

As said in *District of Columbia* v. *Murphy*, 314 U. S. 441, 449:

> "To ascertain its meaning we therefore consider the congressional history of the Act, the situation with reference to which it was enacted and the existing judicial precedents, with which Congress may be taken to have been familiar in at least a general way."

Again at page 454 the court said:

> "A contrary decision would disregard the statements made on the floor of Congress as to the meaning of the statute, fail to give proper weight to the trend of judicial decisions, with which Congress should be taken to have been cognizant. * * *"

Note 8 on page 13 of the government brief is not applicable because the statements there were not of a member in charge of the bill.

Also, regard should be had to the contemporaneous administrative construction of the law. The Treasury Department, in its regulation, published immediately after the enactment of section 115 (f), gave an example which states that a dividend of common on common stock was not subject to tax (this example is in the regulation at p. 52, (government brief). This continued unchanged until 1940 and meanwhile, although enacting revenue acts, Congress did not change the law. It is presumed to have known this regulation and if it intended to tax a dividend of common on identical common stock would have changed

the law. Also, it is to be borne in mind that between the date of the original enactment of this provision of the Revenue Act the Board of Tax Appeals and the courts repeatedly recognized and applied *Eisner* v. *Macomber* (for such recognition see *Foster* v. *United States*, 303 U. S. 118, 121, 122, note 9) but Congress, although enacting revenue laws, never declared a dividend of common on identical common stock should be taxable.

Had Congress intended to tax a dividend of common stock on identical common stock it would have amended section 112 (b) (2) and 112 (b) (3) of the Internal Revenue Code. It is contended in this brief that these sections sustain the decision in the *Sprouse* case and compel the reversal of the decision in the case at bar.

Section 112 (b) (2) and Section 112 (b) (3) of the Internal Revenue Code Postpone Taxes on Stock Dividends Until the Same Are Sold.

The decisions of this court in the *Phellis*, 257 U. S. 156; *Rockefeller*, 257 U. S. 176, and *Marr*, 268 U. S. 536 cases resulted in the enactment by Congress of the first non-recognition of gain provisions covering reorganizations, in the Revenue Act of 1924. Congress did so in order that taxes might be postponed where there was no real change in the interest of the shareholder but merely a change in the form of that interest. Under those provisions none of the transactions in those cases, cited at page 32 of the government brief, would have been taxable and such transactions are not taxable now. Note reference in committee report (C. B. 193—part 2, page 189) to "technical constructions which are economically unsound." In Studies in Federal Taxation, Second Series, page 4, note 4, Mr. Paul shows how this court's decision in the *Marr* case resulted in the reorganization provisions being enacted.

A decision below must be affirmed even if the ground upon which it was put below be wrong, if it may be sustained by any facts appearing of record. *Bondholders Committee* v. *Commissioner*, 315 U. S. 189, 192; *Le Tulle* v. *Scofield*, 308 U. S. 415, 421; *Helvering* v. *Gowran*, 302 U. S. 238, 245.

Section 112 (b) (2) of the Internal Revenue Code reads as follows (It is claimed to be applicable in the *Sprouse* case):

> "**Stock for Stock of Same Corporation.**—No gain or loss shall be recognized if common stock in a corporation is exchanged solely for common stock in the same corporation, or if preferred stock in a corporation is exchanged for preferred stock in the same corporation."

In *Marr* v. *United States*, 268 U. S. 536, this court said of *Eisner* v. *Macomber*:

> "It was as if the par value of the stock had been reduced and three (3) shares of reduced par value stock had been issued in place of their two (2) shares, that is, there was an exchange of certificates but not of interest."

With reference to the case at bar, section 112 (b) (3) of the Internal Revenue Code reads as follows:

> "**Stock for Stock on Reorganization.**—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization."

Section 112 (g) of the Internal Revenue Code reads:

> "The term reorganization means * * * (E) a recapitalization."

The facts stated on page two of the government's brief show that the corporation's articles of incorporation were amended on December 11, 1936 to provide that it might issue five hundred (500) shares of One Hundred ($100.00) Dollar par value seven percent cumulative non-voting preferred stock and that ten days later the resolution was passed to distribute this stock to the shareholder. There was, unquestionably, a recapitalization of the corporation (defined by the statute to be a reorganization) and the shares were distributed in pursuance of the plan to the corporate shareholder and under the foregoing quotation from the *Marr* case there was an exchange of the rights represented by the certificates. *Cf. Bass* v. *Commissioner*, 129 F. (2d) 300.

Not only that but the reason and policy of these statutory enactments certainly applies here and the result should not turn on a quibble about the meaning of "exchange." To do so would be to subvert substance to form. As said by the court, through Mr. Justice Black, in *Helvering* v. *Lazarus & Co.*, 308 U. S. at page 255: "In the field of taxation administrators of the laws and the courts are concerned with substance and realities." So is Congress.

Eisner v. Macomber Was Rightly Decided.

At the top of page 5 of its brief the government states the only question (in view of the decision in the *Macomber* case) "is whether the tax is direct and therefore subject to the apportionment requirement." What is a direct tax is not only stated in *Bromley* v. *McCaughn*, 280 U. S. 124, but the briefs in the *Pollock* case exhaust the learning on the subject.

In the *Macomber* case it was decided the tax was "direct" being on the stock itself. The court is not only referred to that decision but to the able brief filed in that case by a former Chief Justice of this court on that question and inasmuch as if and when the court reaches this point we assume it will very carefully read and study that brief, its cogent and convincing arguments are not repeated here.

However, the above quoted argument of the government shows the utter irrelevancy of the statement at the bottom of page 23 and the top of page 24 of the government brief that the courts of Massachusetts and Wisconsin have adhered to their decisions taxing stock dividends after the *Macomber* decision because, although such a tax is a direct tax, the states, unlike the federal government, have authority to levy it without apportionment. *Cf. Pasados* v. *Warner Co.*, 279 U. S. 340, 346. Besides stock dividends were only taxed in Massachusetts for a few years after the *Macomber* case, as pointed out in *Commissioner* v. *Morgan*, 306 Mass. 305. Not only did the legislature repeal the tax but also the Wisconsin court proceeded to limit its decision by holding a stock dividend out of appreciation of assets not taxable. *State ex rel Hanson* v. *Cary*, 191 Wis. 153. Also, the Sixteenth Amendment certainly was not intended to do away with apportionment except as to what was in fact income. Hence, if a stock dividend is not income the quotation on page 25 of the government brief is irrelevant unless it be contended the amendment was intended to authorize a tax on real estate and all direct taxes without apportionment. (The discussion of direct taxes at pages 17 and 18 of the government brief is found in *Bromley* v. *McCaughn*, 280 U. S. 124.)

The Basis of the Macomber Decision Is That One Who Exchanges a Ten Dollar Bill for Ten One Dollar Bills Thereby Receives No Income.

If the above proposition is right then the tax cannot be on income for there is no income. If not on income then, as pointed out in the *Macomber* case brief and held in that case, it is a direct tax on the stock itself which the Constitution requires to be apportioned. In the taxpayer's brief in *Eisner* v. *Macomber*, the former Chief Justice of this court stated the pith of the case as follows:

> *"The dividend takes nothing from the corporation and gives nothing to the stockholder. The corporation is no poorer after it has been paid. THE STOCKHOLDER IS NO RICHER THAN BEFORE AND SO RECEIVES NO INCOME."*

In *Edwards* v. *Chile Copper Co.*, 270 U. S. 452, Justice Holmes said, at page 455:

> "We canot let the fagot be destroyed by taking up each item of conduct separately and breaking the stick. The activities and situation must be judged as a whole."

The government's argument against the *Macomber* case disregards this injunction and separates the decision into parts and tries to break each part separately whereas the decision was made on the situation as a whole.

The doctrine that a stock dividend is not income has been adopted throughout the English speaking world. See the following decisions of the House of Lords: *Commissioners* v. *Blott*, 2 A. C. 171, 195, 202; *Inland Revenue Commissioners* v. *Fisher* (1926), A. C. 395, and by the privy council in an appeal from India: *Commissioners* v. *Mercantile Bank* (1936) A. C. 478. In Australia the high court

overruled its prior contrary decision and followed the *Macomber* case and the courts of Canada have followed it.

Arguing for the taxpayer in the *Blott* case, Sir John Simon said (p. 175):

> "The point is that the stockholder has now got capital asset and that the same thing cannot be at the same time capital in the hands of the company and income in the hands of the shareholder."

Discussing the *Macomber* decision in 37 Harvard Law Review 1, at page 8, Professor Beale says the stockholder has received nothing and unless he sells his stock may never receive anything because the corporation may lose the money the stock represents.

At pages 8 and 40 the government argues a taxpayer is no wealthier immediately before he sells a capital asset than thereafter. If this were so there would be no stores open in Washington or elsewhere. Also there would be no damages for breach of a sale contract because a near vendor would suffer no damage if a buyer backed out of a sale at the last moment. According to the government he would be as well off.

On page 37 the government says *Helvering* v. *Brunn*, 309 U. S. 461, (which was set aside by section 115 of the Revenue Act of 1942) is contrary to the *Macomber* case. That case dealt with an entirely different state of facts. It is possible to sever money from a corporation by a dividend but not buildings (except castles in the air) from land and have them worth anything except to the buyer of old materials. Besides the owner of the land was richer after than before the building was forfeited to him. In the *Brunn* case this court distinguished the situation at pages 468, 469.

The *Kirby* case, cited on page 36 of the government brief was set aside by section 114 of the Revenue Act of 1942 and the Court of Appeals' decisions collected in note 23 on page 37 were decided before a contrary view was announced in *Palmer* v. *Commissioner*, 302 U. S. 63, 69. An increase in the value of property does not result in taxable income. *Bingham* v. *Long*, 249 Mass. 79.

No example can be given to show where the *Macomber* case has restricted Congress. It does not prevent taxing the annual income of a corporation to its stockholders because stock dividends generally are issued against accumulations over a period of years and also the stockholder receiving them may not have owned his stock during the years the corporation earned the profits.

At page 43 it is said the decision impelled Congress to abandon taxing corporate profits accumulated to avoid surtax, to stockholders. If so, this has worked to the benefit of the revenue. For example, in the case of the *Chicago Stock Yards Company*, No. 488 herein, the taxes and penalties due to the method Congress adopted exceeded four million whereas had the profits been taxed to the stockholders instead, the taxes would have only been approximately $1,300,000. (See 41 B. T. A. 611, finding 37.)

The Overruling of Eisner v. Macomber Will Harm the Revenue.

Should the *Macomber* case be overruled taxes will be collected from the people who received stock dividends in reliance on it only for the three years not barred by Statute if the Commissioner, in a sense of justice, does not

declare its overruling not retroactive by virtue of the power granted him under section 3791 (b) of the I. R. C. or if Congress does not do so. After *Helvering* v. *Hallock*, 309 U. S. 106, had overruled the *St. Louis Trust Co.* case the Commissioner, in T. D. 5008 C. B. 1940-2, page 286, declared the decision not retroactive as to trusts created between the date of the *Hallock* and *St. Louis Union Trust Co.* decisions.

Also, if the *Macomber* case is overruled the flood of stock dividends declared from 1920 to 1938 will all take a basis of market value at date of receipt for computing profit upon sale by their owners. (For converse situation see *Bigelow* v. *Bowers*, 68 F. (2d) 839, cer. den. 392 U. S. 656.) The revenue will lose millions unless Congress intervenes. (See testimony of this amicus curiae in 1942 Senate Finance Committee Hearings, page 1021.)

As to the future, the following observation in the 1942 Senate Report, No. 1631, on the capital asset sections, at page 49, is pertinent:

> "The realization of capital gain is entirely a matter within the discretion of the taxpayer. If the rates are too high the government will lose not only income taxes but also stamp taxes upon the transfer of property."

If stock dividends are taxable none will be declared and the market sales which take place when many shares are outstanding will not take place unless the same thing be accomplished through a tax free reorganization in which the corporation recapitalizes and changes the par value of its shares and the stockholders exchange one old share

for a number of new ones. (See argument, *supra*, that this case is substantially the same and should be so treated.)*

CONCLUSION.

At page 45 of its brief the government states the decision below is correct under *Koshland* v. *Helvering*, 298 U. S. 441, because the stock dividend (in this and in the *Sprouse* case) did not represent rights identical to those represented by the stock on which it was declared. See also its response to the petition for certiorari.

If so, it is submitted the court should not go out of its way to reconsider a great constitutional decision which a glance at the citator will show has been cited and followed innumerable times. Since Chief Justice Taney went out of his way in the *Dred Scott* case this court has refrained from doing so.

All of which is respectfully submitted.

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*At no time in the history of this court have so many of its decisions been set aside by Congress as its tax decisions made in the last few years. The following decisions were set aside by the Revenue Act of 1942: **Crane-Johnson Co., v. Helvering**, 311 U. S. 54 and **Northwest Steel Rolling Mills**, 311 U. S. 46, by section 501. **Helvering v. Enright**, 312 U. S. 636, by section 134. **Higgins v. Commissioner**, 312 U. S. 212, by section 121. **Helvering v. Brann**, 309 U. S. 461, by section 115. **United States v. Nummally Investment Co.**, 313 U. S. 584, by section 503. As noted by the court in the **Southwest Consolidated** case, its decision in the **Hendler** case was set aside by the prior revenue act.